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GAS INVENTORY CHARGES

HEARING

BEFORE THE

SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION

OF THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

GAS INVENTORY CHARGES

SEPTEMBER 14, 1989

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Committee on Energy and Natural Resources

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CONTENTS

STATEMENTS

Page

Bingaman, Hon. Jeff, U.S. Senator from New Mexico 1

Domenici, Hon. Pete V., U.S. Senator from New Mexico 5

Hesse, Martha O., Chairman, Federal Energy Regulatory Commission 34

Langdon, Jerry J., Commissioner, Federal Energy Regulatory Commission 126

Lott, Hon. Trent, U.S. Senator from Mississippi 29

Moler, Elizabeth Anne, Commissioner, Federal Energy Regulatory Commission 115

Nickles, Hon. Don, U.S. Senator from Oklahoma 31

Stalon, Charles G., Commissioner, Federal Energy Regulatory Commission 46

Trabandt, Charles A., Commissioner, Federal Energy Regulatory Commission . 82

APPENDIXES

Appendix I

Responses to additional questions 185

Appendix II

Additional material submitted for the record 325

GAS INVENTORY CHARGES

SEPTEMBER 14, 1989

U.S. Senate,
Subcommittee on Mineral Resources
Development and Production,
Committee on Energy and Natural Resources,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:15 a.m. in room SD-366, Dirksen Senate Office Building, Hon. Jeff Bingaman, presiding.

OPENING STATEMENT BY HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

Senator Bingaman. Good morning.

This is an oversight hearing of the Subcommittee on Mineral Resources Development and Production to examine the potential producing sector impacts of the Federal Energy Regulatory Commission's proposed policy statement on interim gas inventory charges, or "GICs 'as they have come to be known, and the implementation of permanent GICs on individual pipelines pursuant to certificate orders issued by the Commission.

A GIC is envisioned as a rate charged by an interstate natural gas pipeline in association with its jurisdictional sales service that is designed to compensate the pipeline for maintaining sufficient inventories of natural gas to supply its sales customers on demand. Gas inventory charges were first proposed by the commission as part of a policy statement issued as part of Order No. 500, and the purpose of this new form of sales rate was to prevent the accrual of future take-or-pay liability.

While the concept of a GIC has received widespread support in the natural gas industry, the implementation of a workable GIC has proven difficult. One of the most contentious issues surrounding GICs involves how the charges should be calculated. In particular, the Commission as an option offered in its proposed policy statement on interim GICs, and some individual pipelines in their applications to implement GICs have proposed tying both the pipeline commodity rate and the inventory charge to the spot market price of natural gas.

In response to these proposals, commenters, and in particular independent natural gas producers, have raised concerns regarding the impact that such pricing formulas might have on the market price for natural gas which in turn, naturally, would affect incentives for exploration and production. Questions have also been raised regarding the legal foundations of such a pricing formula and the impact that it might have upon "market out" clauses in gas purchase contracts between producers and interstate pipelines.

In June of this year, I presided over a subcommittee field hearing in Farmington, New Mexico, concerning the competitiveness of New Mexico natural gas producers and production. In view of testimony received from independent natural gas producers at that field hearing, assertions that the Commission's GIC policy might somehow weaken the incentive to invest in exploration and production are of serious concern to me. For purposes of national energy policy as well as sound regulatory policy under the Natural Gas Act, it is important that a long-term supply of natural gas at affordable prices not be sacrificed unwittingly as the price for achieving the lowest possible price for pipeline system supply gas in the near future.

The subcommittee is pleased to have before it as its first and only panel of witnesses for this hearing the full membership of the Federal Energy Regulatory Commission. On behalf of the subcommittee, I want to extend a warm welcome and thank the Commission for making itself available today. I look forward to the Commission's testimony and to exploring the rationale underlying the commission's GIC policy.

Before proceeding to other important opening statements, I would like to announce that we will leave the record open for an additional 2 weeks until Thursday, September 28 for additional parties to submit written statements.

I would also like to take the opportunity to announce that on Tuesday, September 26, the subcommittee is holding an oversight hearing on natural gas supply and deliverability. The hearing will feature a debate-type form with two prominent natural gas industry experts, Mr. Ken Lay of Enron and Mr. John Sawhill of McKenzie & Co., and we look forward to a very interesting hearing and wanted to make that statement so that anybody who is able to might attend that hearing as well.

Let me defer to my colleagues for any opening statement they may have at this point.

Senator Domenici.

STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR FROM NEW MEXICO

Senator DOMENICI. Thank you very much, Mr. Chairman.

First, let me thank you for agreeing to hold this oversight hearing that Senator Nickles and I requested and let me also say, Mr. Chairman, from the Republican standpoint on the subcommittee, we are confronted with a situation where, at least from my standpoint I am extremely interested in this hearing, and I assume Senator Nickles is, but we have been advised by our Republican leader that at 10:45 we have a brief conference on the drug issue.

Senator FORD. We start voting at 25 and then we have back-to-back votes that probably will take you beyond 45.

Senator DOMENICI. I just wanted to say if there is any way, Mr. Chairman, that there are not enough Senators here and you are finished, we surely do not want to impose on your time. But, from my standpoint, I would surely like to leave it open and keep the witnesses here until we have had our chance for a few questions. If you can see your way clear to do that, I would greatly appreciate it.

Senator BINGAMAN. Well, I will go at least until noon with the hearing, and that should be time enough unless your conference runs very long.

Senator DOMENICI. I do not think it will run that long. I have a detailed statement. I do not think I want to use it at this point. I would ask that it be made a part of the record.

Senator BINGAMAN. I will make it part of the record and all other statements any other Senator wishes to make.

Senator DOMENICI. Let me just articulate my concerns. Frankly, I want to say to the Commission that I am very disturbed about what I see evolving in the name of a gas inventory of a so-called GIC.

First, I want to remind everyone and in particular the distinguished chairperson that it was not very long ago that she attended a ceremony at the White House. I was not there, but I happen to have seen it, and the issue was deregulation of natural gas. And I recall that everyone was rather ecstatic about the fact that we were going to deregulate in a rather short time frame the remainder of natural gas in this country.

And, frankly, the more I look at the policies that you are trying to impose in the name of a GIC which is supposed to be, as I understand the words, the imposition of some charge and the fixed charge in the name of inventory so that you can have a long-term supply for the LDC at the end of the pipeline. That is what it is supposed to be.

I think it is turning out to come perilously close to the reimposition of price controls, and I do not know how you can explain it otherwise in the name of trying to produce long-term contracts and thus, long-term supply. Nothing could be worse than for that to happen. Now, perhaps you can explain to us that it is not so.

Secondly, there are a couple of words of art in the Natural Gas Policy Act that are extremely important, just and reasonable. I am very interested in how you can use just and reasonable in the imposition of a cost mechanism without referring to the sections in the Natural Gas Policy Act that establish the price of natural gas beyond any legal doubt.

I believe the use of those kinds of words in the imposition of a cost mechanism in a GIC is without authority unless you are prepared to say that you do not mean that, that you are merely using the words and it means something else. To me it means the price and it means an abrogation of contracts, and let me suggest that it means the exact opposite to this Senator from what you intended to do to assure long-term supply.

Now, I happen to have one set of facts that I think are important for this committee and important to the industry in the name of producing long-term supplies and long-term deliverability of natural gas. Had your spot market GIC been effective, here is what I understand the effect would have been, Mr. Chairman, and I think these are very important numbers.

If the wellhead price was driven down to spot levels, as feared by Commissioner Trabandt and the Independent Petroleum Association of America, the Commission's gas inventory charge would have been devastating in its impact on producers. And I assume if it is devastating on producers, it does not increase supply.

The energy information data shows that under this assumption if FERC's spot market gas inventory charge had been in place last year—now these are the interesting facts—producers would have sold to the 20 largest pipelines. Those that did would have been denied $1.3 billion in wellhead revenue that they received during 1988. Wellhead prices in our part of the country, Southwest, for example, would have been driven down by 34 percent per mcf, a 17 percent reduction. Thirty-four cents or 17 percent. Rocky Mountain region, 54 percent—excuse me, 54 cents, 28 percent. Appalachian region, 72 cents, 27 percent reduction.

With respect to individual states, I will just quickly tick them off. In Louisiana, 28 cents; in Texas, 29 cents; in Kentucky, 92 cents; West Virginia, 87 cents.

Senator FORD. You notice Kentucky is the hardest hit there.

Senator DOMENICI. It seems to me some of the letters some of us have written to the Commission, if they had the effect of stalling the action that was inevitable be it on one of the particular applicants or on your generic efforts, the letters were all worthwhile.

I am very pleased you have not done anything yet because I think anything I have seen that you plan to do will be ineffective with reference to your ultimate goal and very destructive with reference to the deregulation of natural gas which we all hope will cause enhanced production rather than diminished production.

Thank you very much, Mr. Chairman.

[The prepared statements of Senators Domenici and Lott follow:]

Statement of

Senator Pete V. Domenici (R-NM)

Subcommittee on Mineral Resources Development & Production
Committee on Energy and Natural Resources
Oversight hearing on:
The Potential Producing Sector Impacts of the Federal Energy Regulatory Commission's Proposed Policy Statement on Gas Inventory Charges
September 14, 1989

I want to thank Subcommittee Chairman Jeff Bingaman for agreeing to hold this oversight hearing which both Senator Nickles and I requested.

The issue the Subcommittee is focusing on today is the Federal Energy Regulatory Commission's proposed policy on gas inventory charges and its impact on producers and production.

Although an arcane and complex regulatory matter, the policy the Commission ultimately establishes is, in fact, critical to the entire natural gas industry.

On the one hand, the Commission could design its gas inventory charge policy in such a way as to benefit all segments of the gas industry, from drill-tip to burner-tip; on the other hand, it could design it in a way that would severely harm producers and be very destructive to domestic natural gas exploration and production.

Which direction the Commission is going to take is the paramount concern of this hearing.

Earlier this year I was alerted by the Independent Petroleum Association of America that the Commission was, in fact, planning on putting into place a gas inventory charge that would have severely harmed producers, particularly independents in my state. As a result, on February 14, I wrote to Chairman Hesse to express my deep concern.

My concern was further heightened by the Commission's issuance on May 30 of its Notice of Proposed Policy Statement on interim gas inventory charges. In his concurring opinion, Commissioner Trabandt voiced the same fears as the independents; that under the FERC-proposed spot market gas inventory charge, and I quote:

> . . . pipelines would have no option but to virtually collapse all remaining higher priced contracts to spot prices, or even below.

> I think the conclusion is inevitable -- almost all gas contracts would have to be priced at spot or netback from spot. . . . The net result would be a very immediate "ramp-down" of higher priced contracts with predictable and devastating impact on the producing community.

And this result is apparently what the Commission intends. In his concurring opinion, Commissioner Trabandt also states that he is "satisfied that the primary objective and clear intent of the spot market based [interim gas inventory charge] is just such an immediate nationwide ramp-down of all contracts with prices above current spot prices, in order to render pipeline sales more competitive with other transportation based supplies."

In late June, I was alerted by the Independent Petroleum Association of America that the Commission was again planning on putting in place a gas inventory charge that would hurt producers by driving down wellhead prices to spot market levels. On June 30, I wrote to Chairman Hesse to express my renewed concern.

If wellhead prices are driven down to spot levels, as is feared by Commissioner Trabandt and the Independent Petroleum Association of America, then the Commission's gas inventory charge policy would indeed have a devastating impact on producers. That is confirmed by data prepared at my request by the Energy Information Administration of the Department of Energy. I ask unanimous consent that it be included in the record.

The Energy Information Administration data shows that under this assumption if FERC's spot-market gas inventory charge had been in place last year, producers who sold gas to the twenty largest pipelines would have been denied $1.3 billion in wellhead revenues they actually received during 1988. Wellhead prices in the Southwest, for example, would have been driven down by 34 cents per MCF, a 17 percent reduction; prices in the Rocky Mountain region would have been driven down by 54 cents per MCF, a 28 percent reduction; and in the Appalachian region prices would have been driven down by 72 cents per MCF, a 27 percent reduction. With respect to individual states, in Louisiana the wellhead price would have been driven down by 28 cents per MCF; in Texas it would have been reduced by 29 cents per MCF; in Kentucky it would have been reduced by 92 cents per MCF; and in West Virginia it would have been reduced by 87 cents per MCF. And with reduced wellhead prices, Federal and state royalty revenues would have also been reduced, down roughly $100 million in 1988 alone. For the first half of 1989, the EIA data shows that producers would have lost $842 million.

For an industry savaged over the past several years by falling wellhead prices, such a further loss of revenue would be devastating. But equally as important, over the long run, consumers would also suffer.

While consumers might enjoy lower gas prices in the short run, over the long run unrealistically low prices inevitably lead to reduced exploration and development and, consequently, shortages and higher prices. We have been through that before and I, for one, do not want the industry or the consumer to have to go through that again!

And finally, let me state a key concern that independent producers have with the Commission's ideas. They believe that there are some in the Commission who favor not just implementing spot market gas inventory charges, but more significantly holding the gas commodity portion of these charges to be the "just and reasonable" rate for the purposes of pipeline passthrough. While a spot market gas inventory charge alone would put great downward pressure on wellhead prices, for the Commission to deem that rate to be "just and reasonable" would guarantee that wellhead prices would fall. It would also result in the abrogation of countless thousands of producer-pipeline gas purchase contracts and, most significantly, it would also be a de facto reimposition of wellhead price controls. Put simply, that would be unacceptable.

As the Committee reviews this matter, we must not lose sight of the trees for the forest. In addition to the pending notice of proposed policy, the Commission also has pending before it several individual gas inventory charge proposals put forward by various pipelines. The Commission has already acted on a number of these, and it continues to do so notwithstanding the pendency of the Commission's proposed policy statement. And in at least one case, that of Panhandle Pipeline, I am led to believe that a gas inventory charge was approved by the Commission which may prove to be quite harmful to producers. I hope to learn more about this case today.

In conclusion, I want to restate my support for gas inventory charges -- but only so long as they are designed in a fashion which does not harm domestic gas producers and the energy security of the United States. I also want to take this opportunity to particularly commend Commissioner Trabandt for his unflagging and continued good efforts on this and a number of other matters. His concurring opinion on the Commission's Notice of Proposed Policy Statement is well worth reading, and I ask unanimous consent that it be printed in the record. I also ask unanimous consent that my correspondence with Chairman Hesse also be included in the record.

I look forward to hearing the testimony of each of the five Commissioners and their responses to our concerns and questions.

PETE V. DOMENICI
NEW MEXICO

United States Senate
WASHINGTON, DC 20510

COMMITTEES:
BUDGET
APPROPRIATIONS
ENERGY AND NATURAL RESOURCES
AGING

February 14, 1989

The Honorable Martha O. Hesse
Chairman
Federal Energy Regulatory Commission
825 North Capital Street, N.E.
Washington, D.C. 20426

Dear Chairman Hesse:

I am writing to express my deep concerns about the negative consequences for both U.S. natural gas producers and long-term natural gas supplies if the Commission adopts the proposed interim Transcontinental Gas Pipe Line Corporation gas inventory charge ("GIC"). I understand that the Commission will consider the Transcontinental GIC at its Wednesday, February 15 meeting.

As a general principle, I believe that a properly designed GIC can simultaneously benefit producers, pipelines, local distribution companies and consumers by helping to match gas supply with demand. However, the proposed Transcontinental GIC would appear to be not in keeping with the principles established by FERC Order No. 500, and potentially in conflict with Federal law.

Before the proposed Transcontinental GIC is adopted, there are numerous technical, policy and legal questions that must be fully considered and understood by the Commission.

First, what impact would the proposed GIC have on domestic exploration and long-term natural gas supplies? Would it artificially drive down the wellhead price of natural gas, thereby reducing the incentive for producers to explore for new reserves of natural gas? Would producers, particularly independents, be willing to enter into long-term gas supply contracts at spot market prices? What are the implications for gas supply if the revenues for the purchase of gas at the wellhead may be diverted from producers to the pipeline? What are the implications for gas supply when the purchase price is indexed to a "spot market" price? And what evidence is there that the proposed price index would, in fact, accurately reflect Transcontinental's gas purchases? What assurance does the Commission have that the proposed use of the "spot market" price by Transcontinental to determine its GIC cannot be manipulated by the pipeline itself, as it is a major player in the region?

Second, what impact would the proposed GIC have on natural gas producers, particularly independents? Would it encourage the pipeline to abrogate ("market out") existing supply contracts with producers? How would that affect independent producers' financial viability?

Third, is the proposed GIC in keeping with Federal law and existing Commission regulations? Would the proposed GIC allow Transcontinental to recover more than the cost of purchased gas in the gas cost component of its jurisdictional sales rate? Would that be lawful? If Transcontinental is allowed to recover a margin, or profit, in the purchased gas component of its rates, rather than being held to a dollar-for-dollar passthrough of purchased gas costs, would it be allowed to retain this profit? Why shouldn't the pipeline be required to pass that on to its customers? If Transcontinental is allowed to add a "profit" for itself in the purchased gas component of its rates, is the Commission, in effect, avoiding its duty under the Natural Gas Act to see that all rates for sales in interstate commerce for resale are "just and reasonable." If not, how will the Commission insure that all such rates and charges are "just and reasonable" as is required by Federal law and Commission precedent? If the Commission does not intend to exercise its jurisdiction under the Natural Gas Act to insure that Transcontinental's rates and charges are "just and reasonable", what is the effect, if any, of Title I of the NGPA on sales in interstate commerce for resale by the pipeline with a GIC? For example, could Transcontinental itself produce at the wellhead low-priced "old gas" and resell it at a price that exceeds the maximum lawful price? Similarly, could it purchase low-priced "old gas" from a producer and resell it at a price that exceeds the maximum lawful price? If the pipeline were allowed to do this, would producers supplying the pipeline also be excused from maximum lawful prices -- or just the pipeline? If Transcontinental is allowed to make a profit by marking up the price of purchased gas, would it still be permitted to recover a full return from its customers? In other words, would the GIC give the pipeline two profit centers -- the return on equity, or profit, as well as a new profit center in the purchased gas component of the rates? Will the GIC include only gas inventory costs, or can other costs be included? When a pipeline with a GIC is allowed to make some form of annual or monthly charge, in addition to the commodity charge for the gas when sold, must this annual or monthly charge be flowed through to the producers to compensate them for holding gas in the ground pending request for service, or is this annual or monthly charge also a new potential profit center for the pipeline? Is it in fact possible for the Commission to make the requisite finding that the markets for gas are workably competitive when new competitors of the pipeline are offered only interruptible service, and then at rates equal to, or greater than, the firm rates? In summary, is the Commission fully convinced that the proposed Transcontinental GIC would be legally sustainable? Would it violate the spirit or the letter of the Natural Gas Act, the Natural Gas Policy Act of 1978, or FERC Order No. 436/500?

At a time when the United States is experiencing declining domestic production and increasing foreign energy dependency, any Commission action which tends to reduce domestic exploration and production would, in my opinion, be ill-advised. Until the issues and questions outlined above, as well as numerous other significant technical, legal and policy questions are fully explored and their implications are completely understood, Commission action on the Transcontinental GIC would clearly be premature.

And finally, because the Transcontinental GIC involves fundamental matters of energy policy, I would strongly urge the Commission to withhold action until such time as Department of Energy Secretary-designate Watkins has had an opportunity to review the matter and to provide to the Commission the Department's judgment on this matter.

Please make this letter a part of the public record in the appropriate dockets.

Sincerely,

Pete V. Domenici

Pete V. Domenici
United States Senator

PVD:HU

cc: Commissioner Trabandt
Commissioner Stalon
Commissioner Moler
Commissioner Langdon

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United States Senate

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

June 14, 1989

The Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources and Development
Committee on Energy and Natural Resources
U.S. Senate
Washington, D.C. 20510

Dear Jeff:

There has been a recent regulatory development that poses a great threat to domestic gas producers, particularly independent gas producers located in New Mexico. I want to call the Subcommittee's attention to this matter and to urge that it hold an oversight hearing in order to explore the implications for natural gas producers and U.S. energy policy.

The matter I am referring to is the Federal Energy Regulatory Commission's May 30 issuance of a Notice of Proposed Policy Statement (PL89-1-000) on "interim gas supply charges and interim gas inventory charges".

The policy statement proposes two alternative gas inventory charges, including a spot-market GIC. If the spot-market GIC alternative is adopted, the consequences to producers, particularly independent producers, would be significant. Commissioner Trabandt, in his separate written comments to the proposed policy statement, succinctly stated the consequences to producers:

> [With the spot-market GIC] pipelines would have no option but to virtually collapse all remaining higher priced contracts to spot prices, or even below. I think the conclusion is inevitable -- almost all gas contracts would have to be priced at spot or a netback from spot.... The net result would be a very immediate "ramp-down" of higher priced contracts with predictable and devastating impact on the producing community.

On February 14, 1989, I wrote FERC Chairman Hesse about this very matter, expressing my deep concern about the negative consequences for both U.S. natural gas producers and long-term natural gas supplies if the Commission adopted a spot market GIC. I understand that you consigned a letter with Senators McClure, Wallop and Nickles about this same matter.

In my February 14 letter, I set out a number of issues that I am concerned about, and I posed a number of questions. To date Chairman Hesse has not responded to my letter; it is my understanding that she has not responded to your letter either.

Accordingly, I would urge that the Subcommittee on Mineral Resources Development and Production hold an oversight hearing on this matter so that we can explore this issue with the Commission and other appropriate witnesses. I would hope and urge that you would invite all five FERC Commissioners to appear at the hearing. Only by doing so would the Subcommittee be able to gain a perspective on the issue.

I want to thank you in advance for holding this hearing. This is not just a matter which affects our state and other gas producing states, it is a matter which has impacts on U.S. energy policy.

I look forward to working with you on the most important matter.

Sincerely,

Pete V. Domenici
Ranking Republican Member
Subcommittee on Energy
Research and Development

PVD:HU

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

CHAIRMAN

June 30, 1989

Honorable Pete Domenici
United States Senate
Washington, DC 20510

Dear Senator Domenici:

This is a supplemental response to your February 14, 1989, inquiry regarding the Commission's consideration of an interim Gas Inventory Charge (GIC). As you may recall, my March 10, 1989, initial response was at a time when the Commission was still in the early stages of discussing and considering a wide variety of interim GIC issues. This is reflected by the fact that the Commission's policy on interim GICs continued to evolve over the next several months. It was not until May 30, 1989, that the Commission did act on interim GICs by issuing a Notice of Proposed Policy Statement (copy enclosed). Thus, to reiterate, prior to May 30th, it would have been premature and inappropriate to address the merits of your letter.

I continue to be committed to timely implementation of the Commission's gas inventory charge policy. Pipeline proposals for gas inventory charges are being handled as expeditiously as possible. Many of those proposals are contested, and therefore the Commission cannot act until the contested issues are resolved.

It may be appropriate to implement interim gas inventory charges to be used by a pipeline until the Commission is able to act on its permanent gas inventory charge proposal. The Commission's proposed policy statement on the design of interim gas inventory charges is subject to notice and comment, so that interested parties can assess the impact of interim charges on the various segments of the gas industry. Comments on the proposed policy statement from all interested persons are now due on July 14, 1989, with reply comments due on July 31, 1989.

In addition, in order to expedite the implementation of permanent gas inventory charges, on April 27, 1989, in an El Paso Natural Gas Company case, the Commission adopted a new approach to consider applications for permanent gas inventory charges on an expedited basis. The Commission will use written submissions to determine whether a pipeline's markets are sufficiently competitive to warrant approval of its gas inventory charge proposal. This procedure will enable the Commission to make a decision without holding a lengthy formal evidentiary hearing before an administrative law judge. The Commission has approved this expedited procedure in two cases since the El Paso order mentioned above and we expect to utilize it in the future.

Enclosed for your information is a brief explanation of market based gas inventory charges, as discussed in the proposed policy statement on the design of interim gas inventory charges, prepared by the Commission staff. If I can be of any further assistance, please do not hesitate to contact me.

Sincerely,

Martha O. Hesse

Enclosure

Enclosure

Market Based Gas Inventory Charges

As discussed in the proposed policy statement, a gas inventory charge mechanism based on competitive market prices would consist of two parts: a gas commodity charge based on a current market price composite and a gas supply charge which consists of a premium over the gas commodity charge to cover gas costs above the current composite market price and any incentive necessary to stimulate long-term supplies. The two parts of the charge together should be adequate to cover a pipeline's gas purchase costs and to cover a pipeline's take-or-pay costs, such as take-or-pay buyout/buydown settlement payments, contract reformation costs, carrying charges on prepayments or gas inventory charges paid to producers.

The market price mechanism should not force down wellhead prices because the gas inventory charge mechanism as described above does not tie a pipeline's price for gas sold to the combination of the gas commodity charge (composite market price) and the gas supply charge (the premium). This combined pricing mechanism would reflect long-term prices in pipeline/producer contracts and should thereby encourage domestic production and long-term gas supplies by recognition of any necessary premium over current market prices in long-term contracts. Similarly, a market based gas inventory charge should not favor pipelines sales over other supply sources because pipeline customers will have to pay a gas supply charge and commodity charge which may render the total pipeline sales price higher than producer prices. With open access transportation, producers and marketers offer contracts with similar terms and conditions. Gas purchasers will therefore have a wide array of service options.

There is no intention to affect either the pipeline's cost of gas or its contractual relationships with producers. The gas inventory charge mechanism is in essence a rate design method and does not cap the price the pipeline can pay a producer.

J. BENNETT JOHNSTON, LOUISIANA, CHAIRMAN
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[illegible]

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

July 11, 1989

The Honorable Martha O. Hesse, Chairman
Federal Energy Regulatory Commission
825 North Capital Street, N.E.
Washington, D.C. 20426

Re: Docket No. PL89-1-000 -- Proposed Policy Statement on Interim Gas Supply Charges and Interim Gas Inventory Charges

Dear Chairman Hesse:

The Subcommittee on Mineral Resources Development and Production intends to schedule an oversight hearing in September to examine the potential impact upon natural gas production of the Federal Energy Regulatory Commission's proposed policy statement in the above referenced proceeding and individual pipelines' applications for authority to implement gas inventory charges (GICs).

We are concerned about the potential impact that the Commission's proposed "competitive price option" for establishing an interim GIC might have upon long-term gas prices and long-term gas supplies. In particular, we question whether a pricing mechanism premised mainly upon the prevailing short-term spot market price for natural gas will add to the volatility of gas markets and undermine the producing sector's efforts to make the commitments necessary to meet projected demand for natural gas in the future. We cannot help but worry that as a consequence of this proposed policy, long-term natural gas deliverability may be sacrificed in return for achieving the lowest possible price for pipeline system supply gas in the near-term.

We are also concerned that the Commission's ongoing consideration and approval of individual pipelines' GIC proposals on a case-by-case basis may supersede the proposed policy statement on interim GICs and thereby foreclose meaningful consideration of the aforementioned issues. Specifically, it is our understanding that the so-called "paper hearings" on individual pipelines' GIC proposals are limited to the competitiveness of the pipelines' sales markets and do not address issues associated with the producing sector impacts of GICs.

In light of these concerns, we request that the Commission take no action on its proposed policy statement in Docket No. PL89-1-000 until after the subcommittee has held its oversight hearing. We also request that the Commission take no final action on pipeline-specific GIC proposals until after the hearing. We believe that any delay in Commission action occasioned by the subcommittee's hearing to be justified in light of the importance of the national energy issues raised by the Commission's proposed policy statement and individual pipelines' GIC proposals.

Thank you for your attention to our concerns regarding the producing sector impacts of gas inventory charges.

Sincerely,

Don Nickles

Jeff Bingaman
Chairman

Don Nickles
Minority Member

J. BENNETT JOHNSTON, LOUISIANA, CHAIRMAN

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WENDELL H. FORD, KENTUCKY
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United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510-6150

July 11, 1989

The Honorable Martha O. Hesse, Chairman
Federal Energy Regulatory Commission
825 North Capitol Street, NW
Washington, D.C. 20426

Dear Chairman Hesse:

It has come to my attention that the Commission is considering at tomorrow's meeting an order concerning settlement on take-or-pay liability for the Transcontinental Gas Pipe Line Corporation. While I have not seen the order, I am led to believe that it contains a spot-market GIC similar to that which had previously been under consideration by the Commission.

As you know, on February 14 I wrote to you expressing my concerns about the proposed interim Transco GIC. A copy of that letter is attached. Four and one half months later you responded to my letter but without addressing any of my concerns or questions. Frankly, it is unsatisfactory.

You state in your June 30 letter to me that "prior to May 30, it would have been premature and inappropriate to address the merits of your letter." Whether or not that may be true, by acting on these individual pipeline GICs, you are making decisions on matters on which I expressed concern in my February 14 letter to you. I do not understand why you feel constrained from responding to my concerns, but free to make decisions and act on these matters.

While I believe that the Commission must take action to address future take-or-pay liability (it has been more than three months since the Order No. 500 take-or-pay buy-down/buy-out program was allowed to expire), the Commission should implement GICs if, and only if, they would be in the overall public interest.

The Commission now has pending before it a Notice of Proposed Policy Statement on Interim Gas Supply Charges and Interim Gas Inventory Charges, Docket No. PL89-1-000, which was issued on May 30, 1989. Since then, the Commission has acted in the Panhandle case which has features that can be characterized fairly as a spot market GIC; and you now have before you at tomorrow's meeting another proposed spot market GIC.

I am very concerned that the Commission is proceeding in this manner: Why is it acting on individual GICs when there is a proposed policy statement on GICs pending on which the comment period is not yet closed? Will the GIC policy statement be used merely to ratify that which the Commission is doing in individual cases during the pendency of the notice, as opposed to being the procedure by which the policy is to be established?

In his concurring opinion on the proposed GIC policy statement, Commissioner Trabandt succinctly stated one key concern I have with a spot market GIC:

> [With the spot-market GIC] ... pipelines would have no option but to virtually collapse all remaining higher priced contracts to spot prices, or even below. I think the conclusion is inevitable -- almost all gas contracts would have to be priced at spot or a netback from spot.... The net result would be a very immediate "ramp-down" of higher priced contracts with predictable and devastating impact on the producing community.

If Commissioner Trabandt's analysis is realized, then a spot market GIC would have a significant negative impact on domestic exploration, which would adversely affect the short and long-term price and supply of natural gas as well as our level of foreign energy dependency. These are all matters of national energy policy which must be carefully considered.

Commissioner Langdon recently indicated that he too has a number of concerns about a spot market GIC. In his dissent in the Panhandle case he stated that:

> The general propriety of using "spot market" prices to establish a gas pricing formula has been identified as an issue requiring further evidentiary submissions in various gas inventory charge (GIC) proceedings. I question whether the Commission has sufficient evidence here to conclude that Panhandle's proposed use of prior month's spot market prices, as modified by the advance posting requirement, meets the just and reasonable standard under the Natural Gas Act. In particular, I am concerned that delays in reporting spot market prices will not provide a current, reliable reference and that Panhandle's sales will influence the spot market prices in the midcontinent area. (Footnotes omitted.)

While I understand that there may be those who would want the Commission to act as quickly as possible to implement GICs, I believe that the overall public interest would be best served by affording the Commission an opportunity to review this matter carefully in the proposed GIC policy statement before the Commission acts on any additional GICs. Accordingly, I specifically request that the Commission defer action on all pending matters involving a GIC until such time as the Commission acts on the proposed GIC policy statement. The additional time this might entail would be a relatively insignificant delay to a program which is already two years old with only one GIC currently into operation.

I request that this letter be made part of the official record in the Transco matter, and that a copy be given to each of the Commissioners for their consideration and action at tomorrow's meeting.

Sincerely,

Pete

Pete V. Domenici
United States Senator

cc: Commissioner Trabandt
Commissioner Stalon
Commissioner Langdon
Commissioner Moler

Table 1A. Average Wellhead Purchase Costs (PGA) and Supply Area Spot Market Average Prices, for 20 Major Interstate Pipeline Companies, 1988

(Volume in Billion Cubic Feet, Price in Dollars per Thousand Cubic Feet)

Pipeline Name	1988 Wellhead Purchases (PGA)[a]			1988 Annual Average Spot Price (Based on FERC Methodology)[d]	Spot Market Pricing Alternative	
	Volume[b] [c]	As a Percent of Total Purchases	Weighted Average Wellhead Price		Difference Between Average Wellhead and Spot Price (E less D)	Revenue Difference If All Purchases At Spot Price Levels (In Millions)[e] (B times F)
(A)	(B)	(C)	(D)	(E)	(F)	(G)
ANR Pipeline Co	168	99	2.14	1.62	-0.52	-87.4
Colorado Interstate Gas Co	157	99	1.52	1.47	-0.05	-7.9
Columbia Gas Transmission Co	361	85	2.31	1.66	-0.65	-234.7
CNG Transmission Co	82	41	2.84	1.74	-1.10	-90.2
El Paso Natural Gas Co	201	99	1.76	1.58	-0.18	-36.2
Florida Gas Transmission Co	147	61	1.99	1.70	-0.29	-42.6
K N Energy Inc	64	85	1.63	1.53	-0.10	-6.4
Natural Gas PL Co of America	132	35	2.05	1.64	-0.41	-54.1
Northern Natural Gas Co	369	75	1.45	1.64	0.19	70.1
Northwest Pipeline Co	90	67	1.94	1.48	-0.46	-41.4
Panhandle Eastern Pipeline Co	69	96	2.29	1.60	-0.69	-47.6
Southern Natural Gas Co	149	99	2.28	1.66	-0.62	-92.4
Tenneco Inc	349	90	1.85	1.66	-0.19	-66.3
Texas Eastern Transmission Co	599	82	1.76	1.74	-0.02	-12.0
Texas Gas Transmission Co	117	58	2.38	1.66	-0.72	-84.2
Transco Inc	204	99	2.51	1.69	-0.82	-167.3
Transwestern Pipeline Co	82	99	2.17	1.55	-0.62	-50.8
Trunkline Gas Co	167	100	2.20	1.71	-0.49	-81.8
United Gas Pipeline Co	33	62	2.57	1.66	-0.91	-30.0
Williams Natural Gas Co	175	96	2.15	1.47	-0.68	-119.0
Total	3,715	NA	1.99	NA	NA	-1,282.2

[a] The Purchased Gas Adjustment (PGA) data base contains gas purchase data dating from 1984, of interstate purchase volumes and average price levels by NGPA pricing category. It is a good source of data regarding the purchase of natural gas under long-term system supply contracts.

[b] Because PGA reports are filed on a staggered basis by the individual pipelines, only a few pipeline PGA's contain purchase coverage periods ending on December 31. For the those that do not, it was necessary to impute an annual volume based on the purchase levels reported in two consecutive filings. As a result, the annual purchase volumes shown here will not necessarily agree with other data sources reporting annual data. The levels shown here therefore, should be considered only as relative measures of purchase activities and not as the authoritative annual figures.

[c] Includes only purchases made at the wellhead, at field gathering points, and gas plant outlet points, purchases from other pipelines, imports, LNG, or of synthetic gas are excluded.

[d] Calculation of the spot market price followed the methodology used by the FERC for the example presented in Appendix A of the Notice of Proposed Policy Statement, May 30, 1989, for computation of a spot market composite price. This procedure involved developing an average of spot market prices by pipeline using data contained in four trade press periodicals. No volumes are associated with the price quotations and thus the averages are derived on an arithmetic basis and are not volume weighted. Because the spot market quotes are published with different frequencies in the trade press reports, an average price for each of the trade press sources is first derived using all observations relating to any region in which the pipeline gathers gas. A composite spot market price for the pipeline is computed by averaging the four trade press results. The FERC computed a monthly spot price. The EIA extended this methodology to derive annual spot market prices.

[e] This is an estimate of the difference in revenue producers would have received if the pipeline had been able to buy the same volume entirely at spot market price levels rather than at prevailing long-term contract price levels. These calculations ignore any other changes to spot or contract price levels that might have occurred as a result of such actions.

NA = Not applicable

Source: Spot Prices: Industry Trade Press (Inside FERC, Natural Gas Intelligence, Natural Gas Week, Gas Daily). Wellhead: Federal Energy Regulatory Commission (FERC), Purchased Gas Adjustment (PGA) Filings.

Table 1B. Average Wellhead Purchase Costs (FERC Form 11) and Supply Area Spot Market Average Prices, for 20 Major Interstate Pipeline Companies, 1988-1989

(Volume in Billion Cubic Feet, Price in Dollars per Thousand Cubic Feet)

Pipeline Name	1988 Wellhead Purchases (FERC Form 11)		1988 Annual Average Spot Price (Based on FERC Methodology)[b]	1988 Spot Market Pricing Alternative		1989 Wellhead Purchases (FERC Form 11) (January Through June)		1989 Annual Average Spot Price (Based on FERC Methodology) (January Through June)[b]	1989 Spot Market Pricing Alternative	
	Volume[a]	Weighted Average Price		Difference Between Average Wellhead and Spot Price (D less C)	Revenue Difference if All Purchases At Spot Price Levels[d] (In Millions) (B times E)	Volume[a]	Weighted Average Price		Difference Between Average Wellhead and Spot Price (I less H)	Revenue Difference if All Purchases At Spot Price Levels[d] (In Millions) (G times J)
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
ANR Pipeline Co	166	2 14	1 62	-0 52	-86 3	75	2 49	1 54	-0 95	-71 3
Colorado Interstate Gas Co	121	1 67	1 47	-0 20	-24 2	57	1 61	1 36	-0 25	-14 3
Columbia Gas Transmission Co	323	2 41	1 66	-0 75	-242 3	133	2 59	1 61	-0 98	-130 3
CNG Transmission Co	77	3 04	1 74	-1 30	-100 1	30	3 07	1 71	-1 36	-40 8
El Paso Natural Gas Co	297	2 32	1 56	-0 74	-219 8	73	2 13	1 50	-0 63	-46 0
Florida Gas Transmission Co	179	1 96	1 70	-0 26	-46 5	102	2 23	1 65	-0 58	-59 2
K N Energy Inc	66	1 60	1 53	-0 07	-4 8	33	1 74	1 43	-0 31	-10 2
Natural Gas PL Co of America	289	1 86	1 64	-0 22	-63 6	121	1 96	1 57	-0 39	-47 2
Northern Natural Gas Co	396	1 41	1 64	0 23	91 1	112	1 66	[illegible]	-0 09	-10 1
Northwest Pipeline Co	87	1 98	1 48	-0 50	-43 5	21	1 70	1 40	-0 30	-6 3
Panhandle Eastern Pipeline Co	76	2 31	1 60	-0 71	-54 0	28	2 42	[illegible]	-0 90	-25 2
Southern Natural Gas Co	149	2 34	1 66	-0 68	-101 3	69	2 47	1 59	-0 88	-60 7
Tenneco Inc	439	1 95	1 66	-0 29	-127 3	127	2 27	1 60	-0 67	-85 1
Texas Eastern Transmission Co	549	1 74	1 74	0 00	0 0	224	1 92	1 72	-0 20	-44 8
Texas Gas Transmission Co	114	2 39	1 66	-0 73	-83 2	58	2 12	1 61	-0 51	-29 6
Transco Inc	181	2 43	1 69	-0 74	-133 9	41	3 14	1 62	-1 52	-62 3
Transwestern Pipeline Co	97	2 64	1 55	-1 09	-105 7	61	1 88	1 46	-0 42	-25 6
Trunkline Gas Co	174	2 26	1 71	-0 55	-95 7	60	2 16	1 66	-0 50	-30 0
United Gas Pipeline Co	50	2 63	1 66	-0 97	-48 5	13	2 51	1 59	-0 92	-12 0
Williams Natural Gas Co	158	2 28	1 47	-0 81	-128 0	72	1 78	1 35	-0 43	-31 0
Total	3,990	2 05	NA	NA	-1,617 6	1,510	2 14	NA	NA	-841 8

[a] Includes purchases made at the wellhead, at field gathering points, and gas plant outlet points, as well as intracompany transfers (owned production) purchases from other pipelines imports LNG or of synthetic gas are excluded

[b] Calculation of the spot market price followed the methodology used by the FERC for the example presented in Appendix A of the Notice of Proposed Policy Statement May 30 1989 for computation of a spot market composite price This procedure involved developing an average of spot market prices by pipeline using data contained in four trade press periodicals No volumes are associated with the price quotations and thus the averages are derived on an arithmetic basis and are not volume weighted Because the spot market quotes are published with different frequencies in the trade press reports an average price for each of the trade press sources is first derived using all observations relating to any region in which the pipeline gathers gas A composite spot market price for the pipeline is computed by averaging the four trade press results The FERC computed a monthly spot price The EIA extended this methodology to derive annual spot market prices

[c] Prices were based on monthly gas purchase volumes and revenues reported in the aggregate by the pipeline State level prices cannot be derived with FERC Form 11 data In addition becauseof reporting differences between the FERC Form 11 and Purchased Gas Adjustment (PGA) average prices and annual purchase volumes from the two sources are not be directly comparable

[d] This is an estimate of the difference in revenue producers would have received if the pipeline had been able to buy the same volume entirely at spot market price levels rather than at prevailing long-term contract price levels These calculations ignore any other changes to spot or contract price levels that might have occurred as a result of such actions

Note Totals may not equal sum of components due to independent rounding

Source Spot Prices Industry Trade Press (Inside FERC, Natural Gas Intelligence, Natural Gas Week, Gas Daily). Wellhead Federal Energy Regulatory Commission (FERC),Form 11, "Natural Gas Pipeline Company Monthly Statement."

Table 2. Supply Area Spot Market Average Prices and Weighted Average Wellhead Purchase Costs (PGA), by Region and for Selected Producing States, 1988

(Volume in Billion Cubic Feet, Price in Dollars per Thousand Cubic Feet)

Region and State Name	1988 Wellhead Purchases (PGA)		1988 Spot Prices[a]		
	Volume[b]	Weighted Average Price	Annual Average[c]	Lowest Quoted	Highest Quoted
Southwest					
Arkansas	14	1.52	NA	NA	NA
Louisiana[d]	1,733	2.01	1.73	1.27	2.50
Oklahoma	213	1.88	1.50	1.18	2 [illegible]
Texas[d]	803	1.94	1.65	1.22	2.23
Overall Area[e]	2,763	1.98	1.64	1.18	2.50
Southeast					
Alabama	25	2.85	NA	NA	NA
Mississippi	69	2.56	1.98	1.73	2.39
Overall Area[e]	94	2.62	NA	NA	NA
Rocky Mountains					
Colorado	47	2.23	1.37	1.14	1.67
New Mexico	267	1.80	1.90	1.67	2.15
Utah	23	1.93	NA	NA	NA
Montana	31	1.32	NA	NA	NA
Wyoming	166	2.23	NA	NA	NA
Overall Area[e]	534	1.95	1.41	1.11	2.15
Mid-Continent					
Kansas	188	1.38	1.56	1.23	1.97
Overall Area[e]	188	1.38	1.57	1.26	1.93
Appalachian					
Kentucky	13	2.85	1.93	1.77	2.33
Ohio	13	2.49	1.95	1.72	2.29
West Virginia	74	2.80	1.93	1.75	2.27
Others[f]	36	2.36	NA	NA	NA
Overall Area[e]	136	2.66	1.94	1.47	2.50
Total (including Offshore)	3,715	1.99	NA	NA	NA
Federal Offshore					
Louisiana	1,249	1.93	1.74	1.36	2.14
Texas	197	2.49	1.69	1.30	2.06
Overall Area[e]	1,446	2.03	1.70	1.30	2.14

[a] Spot market prices are the minimum, maximum and unweighted average of price quotes reported in the geographic area(s) during 1988.

[b] Area purchase volumes based on Purchased Gas Adjustment (PGA) reports for 20 major interstates only. Does not include purchases from other pipelines or imports. Includes only purchases made at the wellhead, at field gathering points, and gas plant outlet points, purchases from other pipelines, imports, LNG, or of synthetic gas are excluded.

[c] Calculation of the spot market price followed the methodology used by the FERC for the example presented in Appendix A of the Notice of Proposed Policy Statement, May 30, 1989, for computation of a spot market composite price. This procedure involved developing an unweighted average of spot market prices by pipeline using data contained in four trade press periodicals. No volumes are associated with the price quotations and thus the averages are derived on an arithmetic basis and are not volume weighted. Because the spot market quotes are published with different frequencies in the trade press reports, an average price for each of the trade press sources is first derived using all observations relating to any region in which the pipeline gathers gas. A composite spot market price for the pipeline is computed by averaging the four trade press results. The FERC computed a monthly spot price. The EIA extended this methodology to derive annual spot market prices.

[d] Includes offshore Gulf of Mexico production.

[e] Average spot prices pertaining to each area were derived based on the total number of spot market observations extracted on behalf of those of the 20 interstate pipelines acquiring gas in the region.

[f] New York, Pennsylvania, and Virginia.

NA = Not available.

Note: Totals may not equal sum of componenets due to independent rounding.

Source: Spot Prices: Industry Trade Press (Inside FERC, Natural Gas Intelligence, Natural Gas Week, Gas Daily). Wellhead: Federal Energy Regulatory Commission, Purchased Gas Adjustment Filings.

Table 3A. Cumulative Volume of PGA Interstate Gas by State and Price For Major Interstate Pipeline Companies, 1988

State	Wellhead Pricing Segment									
	Less Than $1.00	Less Than $1.51	Less Than $2.01	Less Than $2.51	Less Than $3.01	Less Than $3.51	Less Than $4.01	Less Than $4.51	Less Than $5.01	Total
	Cumulative Purchased Gas Volumes (Bcf)									
20 Major Interstate Pipelines										
Alabama	2	3	7	9	10	18	23	24	24	25
Arkansas	a	8	12	13	13	13	13	14	14	14
Arizona	0	a	a	a	a	a	a	a	a	a
Colorado	5	14	29	38	40	42	45	46	46	47
Florida	a	a	1	1	1	1	1	1	1	1
Illinois	0	0	0	a	a	a	a	a	a	a
Kansas	96	121	156	160	168	178	182	183	184	188
Kentucky	2	3	3	7	10	10	11	11	11	13
Louisiana	248	401	982	1,359	1,541	1,598	1,616	1,623	1,675	1,733
Mississippi	a	7	50	52	53	56	56	61	61	68
Montana	10	21	29	29	31	31	31	31	31	31
New Mexico	36	124	215	224	233	241	252	259	262	267
New York	a	a	a	5	5	5	5	5	5	5
Ohio	1	1	2	10	12	12	12	13	13	13
Oklahoma	37	108	151	173	183	191	198	202	203	213
Pennsylvania	a	1	2	17	25	25	25	25	25	26
Texas	159	298	506	616	686	728	753	768	779	803
Utah	5	8	11	14	21	22	22	22	22	23
Virginia	1	1	2	3	4	4	4	4	4	4
West Virginia	6	8	12	32	52	60	64	66	68	74
Wyoming	6	69	120	128	134	137	145	146	152	166
Subtotal	615	1,196	2,268	2,890	3,223	3,373	3,457	3,502	3,579	3,715
All Other PGA Filers	23	65	162	231	283	300	313	318	337	347
Grand Total	638	1,260	2,430	3,121	3,506	3,673	3,770	3,820	3,917	4,062
	Cumulative Percent of Purchased Gas Volumes[b]									
20 Major Interstate Pipelines										
Alabama	7	13	28	37	41	73	91	96	98	100
Arkansas	1	62	88	98	99	99	100	100	100	100
Arizona	0	100	100	100	100	100	100	100	100	100
Colorado	11	31	62	81	86	90	95	97	97	100
Florida	25	33	100	100	100	100	100	100	100	100
Illinois	0	0	0	19	91	91	91	100	100	100
Kansas	51	65	83	85	90	95	97	97	98	100
Kentucky	17	19	22	54	76	77	81	82	82	100
Louisiana	14	23	56	78	89	92	93	94	97	100
Mississippi	0	10	72	76	77	80	81	88	88	100
Montana	32	67	93	94	100	100	100	100	100	100
New Mexico	14	47	80	84	87	90	94	97	98	100
New York	0	1	3	83	90	91	91	94	100	100
Ohio	9	9	14	76	89	94	94	95	95	100
Oklahoma	17	50	71	81	86	89	93	95	95	100
Pennsylvania	2	3	9	65	93	95	96	96	96	100
Texas	20	37	63	77	85	91	94	96	97	100
Utah	22	38	47	63	95	97	98	98	98	100
Virginia	33	33	34	61	94	98	99	99	99	100
West Virginia	7	11	16	43	70	81	86	89	92	100
Wyoming	4	42	72	77	81	83	87	88	91	100
Subtotal	17	32	61	78	87	91	93	94	96	100
All Other PGA Filers	7	19	47	67	82	87	90	92	97	100
Grand Total	16	31	60	77	86	90	93	94	96	100

[a] Less than 0.5 billion cubic feet.

[b] Percent based on the total volume for the respective State (row).

Bcf = Billion cubic feet.

Note: Totals may not equal sum of components due to independent rounding.

Source: Federal Energy Regulatory Commission (FERC), Purchased Gas Adjustment Filings (PGA).

Table 3B. Volume of PGA Interstate Gas by State and Price For Major Interstate Pipeline Companies, 1988

State	Wellhead Pricing Segment									
	Less Than $1.00	$1.00-1.50	$1.51-2.00	$2.01-2.50	$2.51-3.00	$3.01-3.50	$3.51-4.00	$4.01-4.50	$4.51-5.00	Greater Than $5.00
	Purchased Gas Volumes (Bcf)									
20 Major Interstate Pipelines										
Alabama	2	2	4	2	1	9	5	1	1	a
Arkansas	a	8	4	1	a	a	a	a	0	0
Arizona	0	a	0	0	0	0	0	0	0	0
Colorado	5	9	15	8	2	2	2	1	a	1
Florida	a	a	1	a	0	0	0	0	0	0
Illinois	0	0	0	a	a	0	0	a	0	0
Kansas	96	25	35	4	8	10	4	1	1	4
Kentucky	2	a	a	4	3	a	1	a	a	2
Louisiana	245	153	561	396	183	57	18	7	52	58
Mississippi	a	7	43	3	1	2	1	5	a	8
Montana	10	11	8	a	2	a	0	0	0	0
New Mexico	36	88	90	9	9	8	11	7	3	5
New York	a	a	a	4	a	a	0	a	a	a
Ohio	1	a	1	8	2	1	a	a	a	1
Oklahoma	37	71	43	22	11	7	7	4	2	10
Pennsylvania	a	a	1	15	7	1	a	a	a	1
Texas	159	137	210	110	70	42	25	15	11	24
Utah	5	3	2	4	7	1	a	a	a	a
Virginia	1	0	a	1	1	a	0	0	0	a
West Virginia	6	2	4	20	19	9	3	2	2	6
Wyoming	6	63	51	9	6	3	8	1	8	14
Subtotal	615	581	1,072	621	333	150	84	45	78	136
All Other PGA Filers	23	42	98	69	52	17	12	6	19	9
Grand Total	638	623	1,170	691	386	166	97	51	97	145
	Percent of Purchased Gas Volumes[b]									
20 Major Interstate Pipelines										
Alabama	7	7	15	9	4	32	18	5	2	2
Arkansas	1	61	26	10	1	0	1	0	0	0
Arizona	0	100	0	0	0	0	0	0	0	0
Colorado	11	20	31	19	5	4	5	2	0	3
Florida	25	8	67	0	0	0	0	0	0	0
Illinois	0	0	0	19	72	0	0	9	0	0
Kansas	51	14	19	2	4	5	2	0	1	2
Kentucky	17	2	3	32	22	2	4	1	0	18
Louisiana	14	9	32	23	11	3	1	0	3	3
Mississippi	0	10	62	4	1	3	1	7	0	12
Montana	32	35	26	1	6	0	0	0	0	0
New Mexico	14	33	34	4	3	3	4	3	1	2
New York	0	1	2	80	7	0	0	3	6	0
Ohio	9	0	5	62	13	5	0	1	0	5
Oklahoma	17	33	20	10	5	3	3	2	1	5
Pennsylvania	2	1	5	56	29	2	0	0	0	4
Texas	20	17	26	14	9	5	3	2	1	3
Utah	22	15	9	16	32	3	1	0	0	2
Virginia	33	0	1	27	33	5	0	0	0	1
West Virginia	7	3	5	27	26	12	4	3	3	8
Wyoming	4	38	30	5	3	2	5	1	3	9
Subtotal	17	16	29	17	9	4	2	1	2	4
All Other PGA Filers	7	12	28	20	15	5	4	2	5	3
Grand Total	16	15	29	17	9	4	2	1	2	4

[a] Less than 0.5 billion cubic feet.
[b] Percent based on the total volume for the respective State (row).
Bcf = Billion cubic feet.
Note: Totals may not equal sum of components due to independent rounding.
Source: Federal Energy Regulatory Commission (FERC), Purchased Gas Adjustment Filings (PGA).

Documentation Supporting the Calculations

The purpose of these tables is to provide a comparison for 20 major interstate pipeline companies of recent wellhead purchase prices and spot market prices for comparable periods.

Part I. Tables

TABLES 1A and 1B present a summary of pipeline wellhead purchases and purchase costs compared with average spot market prices using two different data sources: the pipeline Purchased Gas Adjustment (PGA) filings for 1988 and the Federal Energy Regulatory Commission (FERC), Form-11, for 1988 and the first six months of 1989. The volume and weighted average wellhead prices are not strictly comparable between the two data sources. Still, many of the wellhead prices and purchase volumes are reasonably close between the two sources. Wellhead price data for 1988 for CNG Transmission, El Paso Natural Gas Co., Natural Gas Pipeline Co. of America, and Transwestern differ by $.20 per Mcf or more between the two sources and any calculations based on these data should be used with caution.

TABLE 2 presents for 6 major supply regions, a comparison for 1988 of the wellhead purchases and prices paid by the 20 interstate companies with the spot market average by State.

TABLES 3A and 3B provide distributions by price categories of wellhead purchases of the 20 interstate pipeline companies. Table 3A provides cumulative totals by pipeline companies across the pricing groups. Table 3B provides the value for each cell.

Part II. Data Sources

Three data sources were used to develop the summary data presented in these tables. The first was the Energy Information Administration's (EIA) PGA database of gas purchase data reported by interstate natural gas pipeline companies. The second was FERC Form-11, "Natural Gas Pipeline Company Monthly Statement." The third was an EIA developed database of natural gas spot market quotations reported by four industry newsletters.

Purchased Gas Adjustment (PGA) Filings

The PGA data base contains gas purchase data, dating from 1984 to the present, that is at a level of detail to permit the compilation of interstate purchase volumes and average price levels at the State level. It reflects the current level of purchasing activity under long-term system supply contracts. The fact that the volumes of gas reported in the PGA has grown progressively smaller over the last several years correlates well with the growing utilization of the natural gas spot market by more and more buyers. The data are available only through December 31, 1988.

FERC Form 11

This form collects monthly information about natural gas purchases by major interstate pipeline companies. This form is used primarily for regulatory purposes and submissions for one month are frequently used to compensate for errors attributable to other months or to account for the effects of regulatory decisions that must be applied retroactively. As a result, month-to-month data for individual companies sometimes show considerable volatility that is not reflective of actual purchase or sales behavior. Thus using the data for month to month analysis is not appropriate, but aggregating the data over longer periods of time is assumed to capture offsetting variations between months, thus yielding more reliable data.

Spot Market Data

The spot market data base that was used in this effort was made up of price quotations reported in four natural gas industry newsletters: ***Inside FERC,*** published bi-weekly; ***Natural Gas Intelligence,*** also published bi-weekly; *Natural Gas Week,* published weekly; and *Gas Daily,* published daily. While data from additional spot market surveys were available, only these four were used in order to maintain the same underlying sources of spot market data used in the FERC example presented in Appendix A of the Notice of Proposed

Policy Statement (NPPS) "Interim Gas Supply Charges and Interim Gas Inventory Charges," published on May 30, 1989 (See Appendix A of the PPPS, "An Example of a Spot Price Composite Calculation").

The spot market survey quotations reported by each of the newsletters are based on different methodologies and area coverage devised by each individual publisher. In the PPPS, the FERC staff presented an examination and analysis of the four separate methodologies and the data itself, and found both to be appropriately suitable to statistical analysis within acceptable limits.

Part II. Processing Summary

Summaries by State of the PGA purchase volumes and wellhead prices were tabulated for the year 1988 for 20 major interstate pipeline companies. Although the information is somewhat dated, use of the PGA information is important as the only source which provides wellhead purchases by State by pipeline company. State and regional information on gas purchases was necessary for the calculation of the spot market prices by pipeline company. The EIA publication *Gas Supplies of Interstate Natural Gas Pipeline Companies, 1987* was also used to identify and subdivide the regions in which each pipeline acquired wellhead supplies. The information in this publication not only verified the States identified in the PGA data but also provided more specifics regarding the localized acquisition areas of the pipelines, especially within the larger producing states of Texas, Louisiana, Oklahoma, and New Mexico. This permitted a more definitive set of locational detail to be developed and incorporated into the spot price calculation.

Information on pipeline company wellhead purchases and price through June 1989 was available from the FERC Form 11. Comparable summaries of wellhead purchase volumes and prices were tabulated by pipeline for the year 1988 and the period January through June 1989.

In developing the spot market prices for the tables, the EIA attempted to duplicate the FERC approach as closely as possible. Because of data availability limitations and processing considerations, minor procedural variations were introduced and are discussed below. With these procedural differences, the EIA spot market price calculation was $0.01 per Mcf lower than the FERC calculation in Appendix A of the NPPS.

To develop the spot market prices for an individual pipeline, the FERC methodology called for an arithmetic average of spot prices for those regions in which the pipeline gathers gas. Specifically, the approach is to

- Calculate for each of the four trade press publications an arithmetic average of the spot market prices for each region in which the pipeline company gathers gas.
- Compute a composite price for the period by averaging the four prices obtained from the first step.

EIA extended this methodology to develop spot market prices by pipeline and by State and region for the year 1988 and the first six months of 1989.

Differences between the FERC example and EIA approach

The EIA database did not contain the *Inside FERC* "Index Value" used in the FERC methodology. Since this item was not available, the mid-points for *Inside FERC* spot market quotes were used instead. Additionally, the EIA spot database contained only biweekly *Gas Daily* survey results and not observations from daily weekly sources as used in the FERC methodology.

Overall, these deviations from the basic FERC methodology made no significant difference in the EIA benchmark versus the FERC results. Table A provides a comparison of the EIA calculations versus the FERC calculations.

Spot Market Regional Definitions

Across the several publications included in the spot market database, the areas of coverage that are reported lack precision. A label such as "Appalachia" in the *Natural Gas Intelligence* survey, for example, carries with it no definitive boundaries. On the other hand, data are reported for the States of Kentucky, Ohio, Pennsylvania and West Virginia by *Inside FERC*. These two series should provide similar coverage of the spot market. For the purposes of our comparison of the two data series, PGA State averages and spot area averages, reasonable judgment was applied in defining how particular areas for spot price data should be extracted for comparison with a particular pipeline purchasing gas in several different areas.

Using a list of the available spot market survey area designations from the spot price database and the PGA pipelines with the States in which each purchased gas at the wellhead, spot market coverage areas were developed and used to extract corresponding area data from the spot price file. An example of this process is as follows:

- According to the PGA data summary by pipeline/state, Colorado Interstate Gas Co (CIG) acquires supplies in Texas, New Mexico, Kansas, Oklahoma, Utah and Wyoming. Upon further examination it is found that, in Texas, CIG acquired its gas specifically in the Panhandle and Gulf areas. Comparing these regional identifications to the spot market file contents we are able to match market areas on the State level for Colorado, New Mexico, Kansas, and Oklahoma. In Texas, however, we can be more precise since quotes specifically from the Texas Panhandle and the Gulf area are separately identifiable.

- Spot market observations specifically identified for Utah and Wyoming, however, are not part of the file, only data within the more general "Rocky Mountain" designation. The "Rocky Mountain" observations, though not as precise, can be used as the surrogate for these states in the regional spot market coverage criteria devised for CIG.

Part IV. Caveats

The following data constitutes a set of estimates of the impact of the recent FERC proposal on the commodity charge the interstate pipelines companies would be allowed to charge for their natural gas. The estimation methodology conforms to the FERC example as provided in Appendix A of the NPPS. The data for the calculations were drawn from the industry publications selected by the FERC. Nonetheless, the derived estimates cannot be interpreted as definitive due to a number of considerations. The major caveats associated with these numbers are as follows:

1. The methodology employed conformed to the procedure as presented by FERC. It should be noted that this methodology was presented as a possible way of computing the average spot market price, however, alternate methods will be considered. In fact, it appears that the computation of the average spot market price ultimately may not rely on any single method, but might vary between pipelines.
2. The data collected for the calculations are dependent on the certain necessary decisions to be made that do impact the results. The regional detail, as well as other relevant characteristics of the data, varies widely between publications. The inclusion or exclusion of data for processing reflects the analysts' judgment or interpretation of the data as they are presented in the various publications.
3. The seasonality that characterizes the recent spot market price data is not captured well in the annual estimates within the tables. Variation across the months of the year may be an essential aspect in evaluating the impact of the proposed change.
4. Much of the data in the Tables are based on transactions prior to the Order 500 take-or-pay settlement date of March 31, 1989. It is likely that a significant amount of contract reformation and renegotiation was being undertaken during this period and that the difference between the wellhead prices and spot market prices may not be as large in the future.
5. The producer revenue differences shown in Tables 1A and 1B show the potential change in revenue for the commodity charge (under the "Competitive Price Interim Gas Inventory Charge") for producers supplying the given volumes of gas to these specific pipeline companies during the time periods shown. These numbers may overstate the impact of the "Competitive Price Interim Gas Inventory Charge" for the following reasons:
   a. This approach ignores any changes in volume which would have occurred in the event that pipeline companies could have increased purchases in the spot market for greater sales volumes.
   b. As noted earlier, the data sources between the FERC Form 11 and the PGA data show a difference of $.20 per Mcf or more for 4 companies: CNG Transmission, El Paso Natural Gas, Natural Gas Pipeline Co., and Transwestern. This results in significant differences for the "revenue difference" calculation shown in Tables 1A and 1B.

Table A. Comparison of FERC and EIA Composite Spot Price Example

	FERC	EIA
Inside FERC:	$1.71	$1.68
Natural Gas Week:	$1.72	$1.71
Natural Gas Intelligence:	$1.61	$1.61
Gas Daily:	$1.69	$1.67
Overall Average:	$1.68	$1.67

September 14, 1989

Statement of U.S. Senator Trent Lott
Before the Senate Committee on Energy and Natural Resources,
Mineral Resources Development and Production Subcommittee

I appreciate the opportunity to express my concerns about certain kinds of gas inventory charge proposals. I also want to acknowledge the able and effective leadership of my colleague Senator Domenici on this important issue. Should the Commission adopt some of the proposals I have seen, I fear negative consequences for natural gas producers in my state of Mississippi and for long-term gas suppliers throughout the country.

As a general principle, I do not have a problem with a gas inventory charge as such. A thoughtfully designed gas inventory change -- one which honors the notion of contract sanctity -- might benefit producers, pipelines, local distribution companies and consumers by facilitating a match between gas supply and demand.

But I do not believe that FERC should make contract sanctity a controversial notion. Congress clearly intended to emphasize the importance of privately negotiated contracts when it expressly removed the Commission's Natural Gas Act jurisdiction to establish just and reasonable rates at the wellhead. Moreover, the Commission has a long history of honoring the sanctity of private contracts, and of insisting that the parties to such contracts negotiate suitable settlement of outstanding issues.

However, some GIC proposals appear to threaten this time-honored principle. A spot-market feature, particularly if coupled with any potential Commission finding that the spot-price is the "just and reasonable price," could permit re-regulation of the price of gas at the wellhead and could have the unintentional and inadvertent effect of abrogating or compromising the contracts of some producers.

To ensure that the Commission's order avoids this effect, the Commission should make explicit not only that it does not intend its proposal to abrogate existing private contracts, but that in fact, its order shall not constitute such an abrogation. In addition, it should also specify that its order will not constitute an event triggering "market-out," force majeur, or other private contract clauses of limitation or termination. By taking these measures, the Commission can provide assurance to gas producers that private contracts will be honored.

I regret that I am not able to be present today, and I once again want to commend Senator Domenici for his leadership on this issue.

Senator **Bingaman**. Thank you.

Senator Ford.

Senator **Ford**. I will pass. I just have some questions. Thank you for the opportunity.

Senator **Bingaman**. Senator Nickles.

STATEMENT OF HON. DON NICKLES, U.S. SENATOR FROM OKLAHOMA

Senator **Nickles**. Mr. Chairman, number one, I want to thank you for holding the hearing, and I want to echo the concerns that were raised by my friend, Senator Domenici. I would agree with those.

That is one of the reasons why I think that the chairman and I have written a letter to the Commission expressing some of our concerns.

We have passed legislation to decontrol natural gas, Senator Ford and myself, and Senator Domenici and Senator Bingaman and Senator McClure and Senator Johnston all worked together to make that happen.

I am very concerned that the GIC proposal could be a big step in the wrong direction, a big step towards reregulation, a big step towards saying the spot market prices are "fair and reasonable" and, therefore, would be the price instead of allowing pipelines and producers to set prices.

And I really do not want to be abrogating contracts. I really do not want to be moving towards reregulation of natural gas. I will energetically oppose it.

I will maybe conclude with the concept tell me it is not so. I understand that you have a difference of opinion. I hope to hear that, and I hope to hear that it is not so, and I will look forward to this hearing.

I, like Senator Domenici, have some conflicts, but I am very interested in this issue and will follow it very closely.

If we take a break for the votes, I will plan on returning later to make sure that we have a chance to communicate to the Commission. So, thank you again for holding the hearing.

[The prepared statement of Senator Nickles follows:]

Statement of
Senator Don Nickles (R-OK)

Committee on Energy and Natural Resources
Subcommittee on Mineral Resources Development and Production

Oversight Hearing On
The Potential Producing Sector Impacts of the Federal Energy Regulatory Commission's Proposed Policy Statement
on Gas Inventory Charges

September 14, 1989

I want to commend Subcommittee Chairman Jeff Bingaman for holding this oversight hearing. It is essential that we continue to monitor the regulatory activities of the Federal Energy Regulatory Commission to ensure that they promote competition in the natural gas industry, particularly now that Congress has finally agreed to deregulate the wellhead price of natural gas.

Today, the Subcommittee is focusing on FERC's proposed policy on gas inventory charges. As a general principle, I am very supportive of the concept, as gas inventory charges could help make the market more competitive. But if crafted improperly, both producers and consumers could be harmed.

The Independent Petroleum Association of America has brought to my attention their concern that the Commission's proposed spot market gas inventory charge would harm producers, particularly independents. Their concerns were echoed by Commissioner Trabandt in his concurring opinion in which he stated that the spot market gas inventory charge would drive all contract gas to spot market price, which would devastate the producing community. Department of Energy data shows that in my state of Oklahoma wellhead gas prices would have been reduced by 38 cents per Mcf last year had the spot market gas inventory charge been in effect during 1988.

While lower wellhead prices might benefit consumers in the short-run, over the long-run low prices would inevitably lead to gas shortages and higher prices.

In addition, Oklahoma producers have contacted me with their concerns that, as a part of the spot market gas inventory charge, the Commission could act in a way that could be interpreted as holding the spot price to be the "just and reasonable" rate. Action that could lead to such an interpretation would have the effect abrogating many producer-pipeline contracts, as well as de facto reimposing wellhead price controls. That would not be in keeping the spirit or the letter of the law; Congress just recently repealed wellhead price controls, and I for one would not want to return to the "bad old days."

On July 11, Senator Bingaman and I wrote to FERC Chairman Hesse to express our concerns. In her August 15 response to me, Chairman Hesse indicated that the proposed policy statement is not intended to affect the contractual rights and responsibilities arising under any pipeline's gas purchase contracts. Nevertheless, I still remain concerned, as do the independent producers, that the proposed gas inventory policy could have those effects -- even if not "intended." I look forward to hearing from Chairman Hesse and the other Commissioners as to what they plan on doing to ensure that those consequences will not occur.

Mr. Chairman, I appreciate your holding this hearing. It will help us clarify the Commission's intentions and plans. I want to restate my support for gas inventory charges, which is conditioned on the policy being designed in a fashion that does not harm producers and domestic gas production. I also want to express my appreciation for Commissioner Trabandt's efforts and concerns on this matter which is particularly important to us who represent gas producing regions of the United States.

I look forward to hearing from the Commissioners about other matters which are related to the implementation of a sound gas inventory charge policy, such as making pipeline firm transportation comparable to sales service.

Senator **Bingaman**. Thank you, Senator Nickles.

I am informed one of the votes that is scheduled for 25 after the hour has been done by voice vote. So we still have a cloture vote coming up very quickly, but why not go ahead and start.

Madam Chairman, we are very pleased to have you here. I believe you are the person to start off. We look forward to your testimony.

STATEMENT OF MARTHA O. HESSE, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Ms. **Hesse**. Thank you, Mr. Chairman and Members of the Subcommittee. Good morning. I am pleased to be here to convey my views on the Commission's gas inventory charge policy.

At the outset, let me assure Senator Nickles that it is not so, and I hope that by the time we are finished today we will all understand and accept it.

Before discussing the need for gas inventory charges, it is important to trace briefly recent changes in the gas industry that brought us to this point.

As many of you are aware, the last several years have seen phenomenal changes for the natural gas industry. After years of pervasive and intrusive regulation, Congress enacted the Natural Gas Policy Act of 1978 to unleash competition at the wellhead. The NGPA phased out price controls and encouraged the Commission to assure access to competitively priced gas.

The efforts of the administration, Congress and the Commission to some extent recently reinforced in the Decontrol Act have been a resounding success for the Nation's consumers. Now over 90 percent of all throughput on natural gas interstate pipelines is on and through open access pipelines.

In fact, over two-thirds of all interstate transactions today involve transportation for third-party shippers. As a result, willing buyers and sellers are able to work freely in the market.

The success of and transition to a more competitive gas market, however, has carried with it a price tag. As pipelines moved from acting solely as merchants to being primarily transporters, they still had to deal with the contractual commitments entered into in the 1970s. For as customers increasingly sought the benefits of a competitive wellhead market by securing other gas supply, the pipelines began accumulating take-or-pay obligations. Simply put, supply and demand at least as far as the pipelines were concerned were out of balance.

As a result, take-or-pay obligations grew, creating an impediment to the full implementation of the Commission's open access program. In order to deal with that market impediment and in response to the AGD court, the Commission issued Order 500. That included, as you probably know, a three-pronged approach to address take or pay in the past, present and future.

For the present, a crediting mechanism enables pipelines to receive volumetric take-or-pay credits when they transport gas. For the past, a direct billing equitable sharing mechanism enables pipelines to recover costs for buying out and reforming take-or-pay contracts. In this context, the Commission has collected data on the take-or-pay situation.

From the data received to date, it appears that the equitable sharing mechanism has helped the pipelines resolve for the most part their past take-or-pay problems. It looks like the industry is finally resolving its past problems.

In addition, it appears that these costs have been equitably shared by many—let us say three of the four—major segments of the industry: pipelines; customers; and producers.

To date, 22 pipelines have filed to recover almost $9 billion in settlement costs, including $115 million in costs associated with contracts and litigation or arbitration on March 31. Of this amount, the pipelines are absorbing about 40 percent directly. They are direct billing their customers about 40 percent and assessing the remainder through volumetric charges.

Significantly, pipelines and their customers have received over $44 billion in relief through the settlement payments. Of this amount, $16 billion reflects past take-or-pay relief, $12.5 billion represents future take-or-pay relief, and about $15.5 billion covers contract reformation. This is further evidence that the natural gas industry is moving toward a more competitive framework in which market forces can efficiently balance supply and demand.

As we continue to move toward a fully competitive market, we must allow pipelines as part of the menu of services to be offered to recover the costs of reserving long-term gas supply on a current basis. For the future, Order 500 recognized this need and laid out a set of principles for pipelines to design gas inventory charges.

Gas inventory charges, or GICs as we fondly call them, are an integral part of the Commission's natural gas program. They are intended to allow pipelines to include in their rate on a current basis a payment for maintaining current gas inventories if their customers desire this service.

Just as important, we must devise rates that tell the customer the full price of the gas it purchases at the time the customer makes the purchase decision.

As with our recently issued rate design policy, GICs will help create efficiency because they will place the responsibility for supply decisions on the gas purchasers. Frankly, without a GIC-type mechanism, pipelines are in an inequitable position.

On the one hand, they must stand ready to supply gas up to a certain maximum amount to any sales customer who requests it. On the other hand, they must maintain a gas inventory to do so.

At the same time, customers have increasing access to and take advantage of competitively priced gas. If spot prices are significantly below the pipeline's commodity charge, then customers can naturally be expected to go to the spot market and use the pipeline for transportation service only.

Without a gas inventory charge, the only way a pipeline can recover its gas cost is through its commodity charge. Yet, if customers want gas supply service from the pipeline, the pipeline may have to pay a premium above spot to obtain long-term supply contracts.

As long as its commodity charge is above spot prices, the pipeline may be unable to sell its system supply and, therefore, unable to recover its costs, including the cost of fulfilling its obligation to maintain gas supply.

The gas inventory charge makes it possible for the pipeline to pay gas suppliers a price greater than the spot market price to reserve, if necessary, longer term supply.

There are at least two approaches. The competitive priced GIC puts the premium above spot in a demand charge and allows the commodity charge to stay competitive; and the deficiency-based GIC provides for a penalty if the customer takes less than a certain proportion of the amount they nominate.

I am sure you have all heard varying stories about the implications of using a spot or competitive price reference in a GIC formula. That, of course, is in large part why we are here today. Let me put one main concern to rest. We never envisioned a short-term spot price to be the total price to be charged for supply insurance under the competitively priced GIC alternative.

Rather, the spot market price is a base price upon which a premium can be added. Let me repeat that. The spot market is a base price upon which a premium can be added. This demand charge or premium enables a pipeline to compensate gas supplies for holding supply on a longer term basis.

Put another way, a GIC is intended to compensate the pipeline for the aggregate cost of maintaining its total inventory of gas supply contracts, not—I want to underscore "not"—the cost related to any one particular producer-supplier contract.

The amount of payment under any individual contract between the pipeline and a producer will continue to be determined under the terms of that contract and not by the level set in a Commission-approved GIC.

We are not requiring any one formula for each and every GIC, nor are we mandating any particular approach to contracting for gas supplies. Rather, we are attempting to foster a competitive gas market where contracts are freely negotiated, for in a competitive market producers sell under terms they negotiate, pipelines enter into contracts that meet their customers' needs, and consumers get affordable, reliable service at reasonable prices.

By the same token, we fully expect that the industry's recent experience with fixed price contracts coupled with the newly available economic benefits of open access transportation will influence the structure of long-term contracts. Today many, probably most, long-term contracts contain market-responsive contractual positions.

On May 30, as you know, the Commission issued a proposed policy statement on interim gas supply and gas inventory charges. The proposal includes proposed methods for developing a limited term gas inventory charge and sets out related conditions of service for use until individual pipelines implement permanent gas inventory charges.

Let me say that pipelines are not required to pursue interim gas inventory charges. In fact, they are not required to pursue permanent gas inventory charges. Two pipelines though, Texas Eastern and Transwestern, have accepted permanent gas inventory charge certificates.

More significantly, I think, the Commission has instituted paper hearings for three pipelines to avoid lengthy trial-type hearings.

Well, I am sure you know that I continue to support fully a gas inventory charge. I believe that all sectors of the gas industry will benefit by prompt implementation. While we must avoid supply and demand imbalances, it is important to keep in mind our overall objective: removal of artificial barriers to the efficient operation of gas markets.

Again, I am pleased to be here this morning, and I look forward to the opportunity to discuss our gas inventory charge policy in greater detail.

[The prepared statement of Ms. Hesse follows:]

TESTIMONY OF MARTHA O. HESSE

CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION
Before the Senate Subcommittee on Mineral Resources
Development and Production
September 14, 1989

Mr. Chairman and Members of the Subcommittee: Good Morning. I'm pleased to be here to convey my views on the Commission's Gas Inventory Charge policy. At the outset, let me assure you that the Commission shares the view, as many of you expressed to us by letter last May, that the Commission implement GICs on both a timely and successful basis.

But before discussing the need for GICs, it is important to trace briefly recent events in the gas industry that have brought us to this point.

As many of you are aware, the last several years have seen phenomenal changes for the natural gas industry. After years of pervasive and intrusive regulation, Congress enacted the Natural Gas Policy Act in 1978 to unleash competition at the wellhead. The NGPA phased out price controls and encouraged the Commission to assure access to competitively priced gas. The efforts of the Administration, Congress, and the Commission -- recently reinforced in the Decontrol Act -- have been a resounding success for the nation's consumers.

Now, over 90 percent of all throughput on the natural gas interstate pipeline grid is on open access pipelines. In fact, over two-thirds of all interstate transactions today involve transportation for third party shippers. As a result, willing buyers and sellers are able to work freely in the market.

The success of, and transition to, a more competitive gas market, however, has carried with it a price tag. As pipelines moved from acting solely as merchants to being primarily transporters, they still had to deal with the contractual commitments entered into during the 70's. For as customers increasingly sought the benefits of a competitive wellhead market by securing other gas supply, the pipelines began accumulating take or pay obligations. Simply put, supply and demand --as least as far as the pipelines were concerned -- were out of balance. As a result, take or pay obligations grew, creating an impediment to the full implementation of the Commission's open access program.

In order to deal with that market impediment -- and in response to the AGD court -- the Commission issued Order No. 500. Order No. 500 included a three pronged approach to address take or pay in the past, present and future.

For the present, a crediting mechanism enables pipelines to receive volumetric take or pay credits when they transport gas.

For the past, a direct billing, equitable sharing mechanism enables pipelines to recover costs for buying out and reforming take or pay contracts. In this context, the Commission has collected data on the take or pay situation.

From the data received to date, it appears that the equitable sharing mechanism has helped the pipelines resolve for the most part their past take or pay problems. It looks like the industry is finally resolving its past problems. In addition, it appears that these costs have been equitably shared by many segments of the industry -- pipelines, customers and producers.

To date, twenty-two pipelines have filed to recover almost $9 billion in settlement costs, including $115 million in costs associated with contracts in litigation or arbitration on March 31. Of this amount, the pipelines are absorbing about 40 percent, directly billing their customers about 40 percent, and assessing the remainder through volumetric surcharges.

Significantly, pipelines and their customers have received over $44 billion in relief through the settlement payments. Of this amount, $16 billion reflects past take or pay relief, $12.5 billion represents future take or pay relief, and $15.5 billion covers contract reformation. This is further evidence that the natural gas industry is moving toward a more competitive framework in which market forces can efficiently balance supply and demand.

But as we continue to move toward a fully competitive market, we must allow pipelines, as part of the menu of services to be offered, to recover the costs of reserving long term gas supply on a current basis. For the future, Order No. 500 recognized this need and laid out a set of principles for pipelines to design gas inventory charges.

Gas inventory charges or GICs are an integral part of the Commission's natural gas program. They are intended to allow pipelines to include in their rates, on a current basis, a payment for maintaining gas supply inventories, if their customers desire this type of service. Just as important, we must devise rates that tell the customer the full price of the gas it purchases, at the time the customer makes the purchase decision. And, as with our recently issued rate design policy, GICs will help create efficiency because they will place the responsibility for supply decisions on the gas purchasers.

Without a GIC type mechanism, pipelines are in an inequitable position. On the one hand, they must stand ready to supply gas up to a certain maximum amount to any sales customer who requests it. On the other hand, they must maintain a gas inventory to do so. At the same time, customers have increasing access to, and take advantage of, competitively priced gas. If spot prices are significantly below the pipeline's commodity charge, then customers can be expected to go to the spot market and use the pipeline for transportation service only.

Without a GIC, the only way a pipeline can recover its gas costs is through its commodity charge. Yet, if customers want gas supply service from the pipeline, the pipeline may have to pay a premium above spot to obtain long term supply contracts. But as long as its commodity charge is above spot prices, the pipeline may be unable to sell its system supply and therefore unable to recover its costs, including the cost of fulfilling its obligation to maintain gas supply.

The GIC makes it possible for a pipeline to pay gas suppliers a price greater than the spot market price to reserve, if necessary, longer term supplies. There are at least two approaches: the competitively priced GIC puts the premium above spot in a demand charge and allows the commodity charge to stay competitive; the deficiency-based GIC provides for a penalty if customers take less than a certain proportion of the amount they nominate.

Now I'm sure you've all heard varying stories about the implications of using a spot or competitive price reference in a GIC formula. That's why, in large part, we're here today.

Let me put one main concern to rest. We never envisioned the short-term spot price to be the TOTAL price to be charged for supply insurance under the competitively priced GIC alternative. Rather, the spot market price is a base price upon which a premium can be added. This demand charge, or premium, enables a pipeline to compensate gas suppliers for holding supply on a longer term basis.

Put another way, a GIC is intended to compensate the pipeline for the aggregate cost of maintaining its total inventory of gas supply contracts -- not the cost related to any one particular producer-supplier contract. And the amount of payment under any individual contract between the pipeline and a producer will continue to be determined under the terms of that contract and not by the level set in a Commission approved GIC.

We are not requiring any one formula for each and every GIC. Nor are we mandating any particular approach to contracting for gas supplies. Rather, we are attempting to foster a competitive gas market where contracts are freely negotiated. For in a competitive market, producers sell under terms they negotiate, pipelines enter into contracts that meet their customers' needs, and consumers get affordable, reliable service at reasonable prices.

By the same token, we fully expect that the industry's recent experience with fixed price contracts, coupled with the newly available economic benefits of open access transportation, will influence the structure of long term contracts. Today, many longer term contracts contain market responsive contractual provisions.

On May 30, the Commission issued its proposed policy statement on interim gas supply and gas inventory charges. The proposal includes methods for developing a limited-term GIC, and sets out related conditions of service for use until individual pipelines implement permanent GICs. Pipelines are not required to pursue interim GICs. In fact, two pipelines -- Texas Eastern and Transwestern -- have accepted permanent GIC certificates. More significantly, the Commission has instituted paper hearings for three pipelines to avoid lengthy trial-type hearings.

I continue to support fully a gas inventory charge. I believe that all sectors of the gas industry will benefit by prompt implementation. And while we must avoid supply and demand imbalances, it is important to keep in mind our overall objective: removal of artificial barriers to the efficient operation of gas markets.

Again, I am pleased to be here this morning, and I look forward to the opportunity to discuss our GIC policy in greater detail.

Senator **Bingaman**. Thank you very much. Going down the list of the Commission here, in order of seniority, the Honorable Charles Stalon, Commissioner, is next, and we would be pleased to hear your statement at this time.

STATEMENT OF CHARLES G. STALON, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. **Stalon**. Thank you, Mr. Chairman, for the opportunity to present my views on the proper role of a gas inventory charge in the evolving natural gas markets.

The ultimate defense of Federal Energy Regulatory policy choices must be found in the objectives of the organization. Since the organization is a multimember regulatory body and each Commissioner has substantial discretion in selecting and prioritizing personal objectives, organizational objectives of necessity are compromises of the Commissioners' personal objectives.

Consequently, for precision of thought and expression I emphasize that the objectives I postulate as defenses for policy choices are my own, and at this time not necessarily those of the organization.

During my five years at the FERC, one of my principal regulatory objectives has been to modify the inherited practices and policies of the FERC to create an efficient North American market for natural gas. The creation of such a market requires many things, some of which have been created and others of which are yet to be accomplished.

In particular, an efficient North American market requires deregulation of wellhead prices—which the Congress has now enacted—non-discriminatory access to pipeline transportation capacity—which the FERC has now partially accomplished—and the debalkanization of the interstate and intrastate gas and gas-transportation markets—which is well underway because of Congressional and FERC actions.

These actions, as necessary as they are for the creation of an efficient market for natural gas, are not sufficient. Other actions are also necessary. The topic of today's hearing, gas inventory charges (GICs), is a necessary condition of an efficient market.

If—and I would like to stress this—they are a necessary element if pipeline companies are to remain in the gas merchant business. If pipeline companies do not remain in the gas merchant business, then they may or may not be essential.

Now, gas inventory charges, however, must be discussed in a proper context. A GIC is an element of a pipeline company's rate design and should be recognized as such. That one element can be evaluated only by recognizing how it fits into the pipeline company's overall rate design.

Furthermore, a pipeline company's rate design, I would insist, must be evaluated according to whether it is the best available to further the development and preservation of an efficient market for natural gas.

My position can be stated succinctly: just as Order Numbers 380, 436, 500, 509 and many other FERC orders in recent years should be seen as steps in a march towards an efficient market for natural gas, so also should the creation of GICs be viewed as another such step.

The crucial problem in the GIC debate is that some GIC proposals are in my view steps backwards. That is, they are anticompetitive. Other GIC proposals, on the other hand, are procompetitive. That is, they will improve the competitiveness of and the efficiency of the natural gas markets. Now, despite many minor failures by the FERC in implementing the procompetitive policies for the natural gas market, the FERC led reforms by responding to changes in the economics of the industry and the economics of the industries producing competitive fuels have facilitated the rejuvenation of the natural gas industry.

The natural gas industry is much more competitive than it was five years ago. Pipeline monopoly and monopsony powers are minuscule compared to what they formerly were. Furthermore, that change is probably not reversible.

All parties to this industry must seek to adjust to the existence of competitive natural gas markets and seek to improve their efficiency. The FERC, in particular, should build on past successes by creating rate designs that improve the efficiency of competition. That objective should mold the choice of GICs.

Now, progress towards Order Number 436/500 goals has been disappointingly slow, but time and experience have revealed the wisdom of those goals and the need for renewed efforts to achieve them.

Time does not allow a comprehensive survey of many of the problems yet to be solved in implementing Order Number 436 initiatives. It is, however, worth mentioning some rate design reforms that need immediate attention to facilitate the functioning of the GIC in the competitive natural gas market.

First, current pipeline company rates do not reveal social cost and opportunities with sufficient precision to induce economically efficient actions from PUCs, LDCs, nonregulated pipeline company customers and producers.

Order 436 called for seasonally-differentiated rates and mileage-based rates. We still do not have them. I am convinced, for example, that pipeline capacity during peak periods is seriously underpriced and, conversely, during off-peak periods it is overpriced.

Second, the need for unbundling rates for pipeline company services and for reforming pipeline company transportation rates was emphasized in 436. Until the FERC creates rate designs that (1) clearly distinguish between asset services (that is, the services of transportation and storage) and gas supply services to the GICs and then efficiently prices pipeline and storage capacity and efficiently prices gas, and (4) presents LDCs with a menu of such services and prices—including the terms under which they are available—it will not be possible for local distribution companies to construct optimal gas supply and transportation portfolios.

Third, an important complement to open access, pipeline service is the right of firm customers of the pipeline company to periodically revise their contract demands. It cannot be anything but a major inefficiency to coerce the customer to continue to make payments for contract demand service which the customer does not want while denying that customer the right to sublease it and simultaneously denying this service to other customers, yet that is exactly the policy that FERC has supported since *AGD* v. *FERC*.

Fourth——

Senator BINGAMAN. Commissioner Stalon, we are at the middle of a vote over on the Senate floor. I think perhaps we need to interrupt you and return here as quickly as we can to continue with your statement. We will stand in recess for about ten minutes.

[Recess]

Senator BINGAMAN. The Subcommittee will come back to order. Commissioner Stalon, we interrupted your statement. If you would go right ahead, we would appreciate it. Thank you.

Mr. STALON. I had made three points and was prepared to start the fourth one.

The fourth one is that another institution that is needed so that buyers and sellers can manage risks is a viable futures market for natural gas. Futures markets are essential and natural adjuncts to competitive commodity markets. While few physical transactions are consummated under futures contracts, the price discovery that futures allow is key to fostering the accountability that disciplines markets.

Furthermore, futures permit buyers and sellers of natural gas to select the degree of price risk appropriate to their individual circumstances. Risk sharing is an important part of the natural gas industry. LDCs, end users and producers would be beneficially served by an efficient futures market that allowed such hedging. The FERC should do all it can to aid the development of such a market.

In the particular circumstance of today's natural gas industry, rate design should encourage, facilitate and in my view coerce the separation of the pipeline company's merchant-of-gas role from the pipeline company's transportation-of-gas role. Consequently, Order Number 500, the Commission invited pipeline companies that intended to continue merchant functions to file GICs. GICs become crucially important for pipeline companies and for customers of a pipeline company's merchant role when the pipeline company loses its monopoly power in selling gas and its monopsony power in buying gas.

Since proposed GICs fall into two well-defined categories, it is plausible to assert that in choosing a GIC design, the Commission is choosing whether to use FERC powers to support further movement towards an efficient market for natural gas, or to use FERC powers to retard that movement. I do not believe that the FERC any longer has the power to stop the forward movement, but it does have power to aggravate inefficiencies and slow progress.

In my opinion, "competitive price" GICs, appropriately defined, can make a significant contribution to efficient markets, and "deficiency-based" GICs, however defined, are unnecessary grants of monopoly power to pipeline company merchants that lead inevitably to gas markets less efficient than otherwise attainable.

Deficiency-based GICs are inferior to competitive-priced GICs for four reasons:

First, they represent a tying arrangement between the natural monopoly of natural gas transportation and the potentially competitive natural gas commodity. Consequently, they perpetuate the necessity of regulation of a potentially market disciplined commodity rather than facilitate the process of separating pipeline company monopoly and nonmonopoly services.

Second, they tend to base-load pipeline company merchant services and force competing merchants into a swing role. In a world economy as unstable as the one in which the gas industry must expect to operate, recessions and expansions are inevitable and consequently the demand for natural gas will fall and rise in response to forces far larger than the industry, the FERC or the Nation can control.

A deficiency-based GIC acts, and is intended to act, to isolate the pipeline company merchant from that external instability. It does this by creating incentives for its customers to buy gas from the pipeline company merchant during depressed demand conditions even when the pipeline company merchant's prices are somewhat higher than those of competing merchants.

Third, they tend to balkanize the natural gas market and create barriers to entry for competitive merchants. If one pipeline company merchant can gain stability in an unstable economy with deficiency-based GICs, so can others. In fact, it is conceivable—but barely so—that nonregulated merchants might try deficiency-based GICs.

All, however, cannot gain stability. Widespread use of deficiency-based GICs would result in a gain for some at the expense of others who, when they do respond with a similar tactic, will lower the benefits of all. An industry with widespread use of deficiency-based GICs would be a balkanized industry with customers largely tied to a particular pipeline company.

Fourth, they induce inefficient purchases of gas at times and since the purchasers are largely LDCs who must resell at approximately the price at which they purchase, the inefficient prices are passed on to their customers.

An efficient market will charge customers approximately the marginal social cost of gas in a nationally-competitive—that is, nonbalkanized—market, the market will be the best estimate of that marginal social cost.

Given the nature of the gas industry and those industries producing directly competitive commodities, it is to be expected that under free market conditions the price of gas will rise when demand is growing and fall when demand is falling.

Efficiency demands that end users of gas be required to pay those market-induced, relatively high prices when demand is growing rapidly and that end users be able to buy at those market-induced, relatively low prices when demand is falling. To the extent that demand elasticities are nonzero, such pricing will moderate quantity fluctuations.

Now, competitive-price GICs do not have the faults of deficiency-based GICs. An issue often posed for regulators is whether competition is sufficiently intense to allow discretion in pricing to a regulated firm.

A superior question, and one especially relevant in the GIC rate design, is whether the discretion will intensify or limit competition. I argue that deficiency-based GICs limit competition by encouraging other merchants to adopt deficiency-based GICs. In contrast, a competitive-price GIC will intensify competition by encouraging other pipeline companies which are prevented from imposing deficiency-based GICs, as well as nonregulated merchants, to also adopt competitive-price GICs.

Rivalry will therefore lead to a market determination of a charge necessary to pay for the security of supply or firmness of service demanded by gas buyers.

The determination of a proper, firmness-related GIC charge must await the development of a market for different degrees of firmness of service. I would approve almost any such charge and any commodity price, or any set of such charges, if a pipeline company merchant wants to offer two or more grades of service, provided that customers are free to abandon the pipeline company merchant for other merchants and free to reduce their contract demands. The benefits of creating competition in this dimension of the market is worth the risk of some minor mispricing of grades of service.

Furthermore, I do not see the necessity of interim GICs. If only competitive-price GICs are to be accepted, I would accept permanent GICs now, provided again that current customers are free to cease buying from the pipeline company merchants and free to reduce their contract demands. I would reserve, however, the right for the FERC to review its cost allocative practices so that both pipeline companies and their transportation and sales customers are on notice that transportation costs may rise or fall as a result of such a review.

The decisions by the FERC embodied in Orders Number 380, 436, 500, 509, et cetera, taken in response to the Natural Gas Policy Act, and the Natural Wellhead Decontrol Act of 1989, were based on the conclusion that a competitive market for natural gas, that improved communications between local distribution companies and other end users and producers, would induce the economically optimal prices, both long- and short-term, the optimal reserve production ratios, the optimal exploration and drilling incentives, and optimal use patterns.

That conclusion is well-supported by economic analysis and the history of unregulated intrastate gas markets. I believe that FERC regulatory policies pertaining to the natural gas industry should continue to reflect those conclusions.

The proper problem to be addressed is not whether long-term prices are satisfactory to a subset of industry participants, but whether there are industry structures, under the influence of the FERC, that are limiting or distorting the ability of LDCs and end users or producers or traders from expressing their true preference.

As I stated earlier, and repeatedly, there are such structural distortions. The FERC's work is not done. It should reaffirm its commitment to the creation of a competitive North American natural gas market and should regulate pipeline companies to facilitate the achievement of that objective.

The correct cure for the current deficiencies in competition in natural gas markets is more competition, and more competition at this time means more choices for LDCs and end users, more unbundled rates by pipeline companies, and more efficient rate designs for pipeline company asset and merchant services.

The Commission has already delayed too long in imposing a competitive-priced GIC and it has delayed too long in separating the pipeline company's transportation and merchant roles, and it has delayed too long in coercing the recalcitrant pipelines into nondiscriminatory access and to CD reduction programs and pipeline capacity programs.

In its attempts to proceed cautiously and not harm any major party directly, the FERC in my view has harmed many parties indirectly by lowering the efficiency of the industry below that attainable.

I thank you.

[The prepared statement of Mr. Stalon follows:]

On the Importance of Properly
Designed Gas Inventory Charges

by

Commissioner Charles G. Stalon
Federal Energy Regulatory Commission

to the Hearing

on

the Federal Energy Regulatory Commission's
Proposed Policy Statement on
Interim Gas Inventory Charges
(Docket No. PL89-1-000)

before

the Subcommittee on Mineral
Resources Development and Production

of

the Committee on Energy and Natural Resources

of

the United States Senate

Washington, D.C.

September 14, 1989

I. Prefatory Remarks and Conclusions

The ultimate defense of Federal Energy Regulatory Commission (FERC) policy choices must be found in the objectives of the organization. Since the FERC is a multimember regulatory body and each Commissioner has substantial discretion in selecting and prioritizing personal objectives; organizational objectives, of necessity, are compromises of Commissioners' personal objectives. As the set of Commissioners change, the objectives of the organization usually change, somewhat at least. It follows, as a corollary, that organization objectives are not likely to be unambiguous for some time after Commission membership changes. Consequently, for precision of thought and expression, I emphasize that the objectives I postulate as defenses for policy choices are my own and not necessarily those of the organization.

During my five years at the FERC, one of my principal regulatory objectives has been to modify the inherited practices and policies of the FERC to create an efficient, North American market for natural gas. The creation of such a market requires many things, some of which have been created and others of which are yet to be accomplished. In particular, an efficient, North American market requires, among other things, deregulation of wellhead prices (which the Congress has now enacted), non-discriminatory access to pipeline transportation capacity (which the FERC has now partially accomplished), and the de-balkanization of interstate and intrastate gas and gas-transportation markets (which is well underway because of Congressional and FERC actions).

Those actions, as necessary as they are for the creation of an efficient, North American market for natural gas, are not sufficient. Other actions are also necessary. The topic of today's hearings, gas inventory charges (GICs), is a necessary condition of an efficient, North American market if pipeline companies are to remain in the gas merchant business. Gas inventory charges however must be discussed in the proper context: A GIC is an element of a pipeline company's rate design and should be recognized as such. That one element can be evaluated only by recognizing how it fits into the pipeline company's overall rate design. Furthermore, a pipeline company's rate design, I would insist, must be evaluated according to whether it is the best available to further the development and preservation of an efficient, North American market for natural gas.

My position can be stated succinctly: Just as Order Nos. 380, 436, 500, 509 1/ and many other FERC orders in recent years should be seen as steps in a march towards an efficient, market for natural gas, so, also, should the creation of GICs be viewed as another such step. **The crucial problem in the GIC debate is that some GIC proposals are, in my view, steps backward; that is, they are anticompetitive. Other GIC proposals, on the other hand are procompetitive; that is, they will improve the competitiveness and efficiency of the natural gas market.**

1/ Order Nos. 380, 436 and 500 are cited below where they are discussed. Order No. 509 issued December 9, 1988 required Outer Continental Shelf pipelines to transport on an open-access, non-discriminatory basis. Order No. 509, Interpretation of and Regulations under, Section 5 of the Outer Continental Shelf Lands Act Governing Transportation of Natural Gas by Interstate Natural Gas Pipelines on the Outer Continental Shelf, Docket Nos. RM88-14-001 and RM88-15-000 (December 9, 1988) FERC Stats. & Regs. Regulation Preambles ¶ 30,842. Order No. 509-A Order on Rehearing, 46 FERC ¶ 61,177, issued on February 21, 1989.

Since the GIC debate is one small (but important) element in a major restructuring of the natural gas industry, it is useful to survey the history of regulatory change that has led to the current focus on GICs. Only then can the significance of alternative GIC proposals be evaluated.

Almost eleven years ago, on November 9, 1978, the Natural Gas Policy Act of 1978 (NGPA) 2/, one of five parts of the National Energy Act of 1978, was enacted. That act symbolized many things: Two of those things were the (1) nadir of federal natural gas regulation and (2) the nadir of the natural gas industry itself. A view of the industry current at the time was that it would play a diminishing role in the nation's energy mix. That view proved to be wrong. One of the unanticipated consequences of this mixed-purpose piece of legislation was to create conditions for the industry's rebirth. Like the Phoenix that rises from its own ashes, the industry found conditions for a new life in the NGPA. One of those life-giving conditions was improved ability of producers to respond to market incentives in the production of natural gas.

Almost four years ago, on October 9, 1985, the FERC issued its Order No. 436. 3/ This order recognized the opportunity to build a revived industry around market-disciplined producers by changing the role of regulated pipeline companies and local distribution companies (LDCs). The objective of Order No. 436, broadly stated, was to intensify market discipline on all players and make prices, in regulated and nonregulated sectors, signal the need for economically efficient actions from all players, from producers to end users. One by-product of Order No. 436 was to signal an intent to shift certain crucially important decision powers affecting the industry from the FERC to state public utility commissions (PUCs) and to shift others to markets. Power shifted to markets cannot easily be shifted back to regulators.

One indication that the natural gas industry has been reborn is found in recent statements emphasizing the possibility and

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2/ 15 U.S.C. 3301, et seq.

3/ Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (Oct. 18, 1985), FERC Stats. & Regs. [Regulations Preambles 1982-1985] ¶ 30,665 (1985), modified, Order No. 436-A, 50 Fed. Reg. 52,217 Dec.23, 1985), FERC Stats. & Regs. [Reg. Preambles 1982-1985] ¶ 30,675 (1985), modified further, Order No. 436-B, 51 Fed. Reg. 6398 (Feb 24, 1986), III FERC Stats. & Reg. ¶ 30,688, reh'g denied, Order No. 436-C, 34 FERC ¶ 61,404, reh'g denied, Order No. 436-D, 34 FERC ¶ 61,405, reconsideration denied, Order No. 436-E, 34 FERC ¶ 61,403 (1986).

desirability of building on natural gas as a major element in the nation's energy future. This view has now become a part of the nation's conventional wisdom. All the government sponsored energy policy proposals I have seen in the last year or so emphasize the opportunity for natural gas to play an increasingly important role in the North American economy.

But opportunities must be grasped. Economic history is a record of opportunities grasped and opportunities fumbled. If regulators are to grasp current opportunities to provide the nation with something it has never had, that is, with an efficient natural gas industry that complements other energy industries and serves the remainder of the economy to its maximum potential, they must distinguish between what regulatory agencies have inherited and what they must create.

II. Natural Gas Regulation Before the NGPA 4/

A. The natural gas system before Phillips. 5/

Perhaps the most accurate, simple description of the system of natural gas regulation before, and for sometime after, the Phillips decision of 1954, is that the Federal Power Commission (FPC), predecessor of the FERC, was essentially a promotional agency. This role developed naturally out of the economic circumstance of the early industry. Natural gas, in these early years of the industry, was found largely as a by-product of the search for oil. Consequently, optimal pricing of gas, in contrast to optimal pricing of the transportation of gas, was not a serious objective. The principal focus for the FPC was to decide how risks should be allocated.

Building long-distance, long-lasting pipelines raised two risks: the risk that gas supplies would not be sufficient to fill the pipelines for a period long enough to recover their costs, and the risk that end-use markets would be lost before the capital costs were recovered. In order to compromise the risk aversion demands of LDCs, pipeline companies and financial markets, the FPC adopted a two-part strategy.

4/ This and the next part of the paper is based partly on an earlier one. See Charles G. Stalon, "New Challenges to State Regulation of Natural Gas in the Context of FERC Rulemaking," Public Utility Regulation in an Environment of Change, eds., Patrick C. Mann and Harry M. Trebing (MSU Public Utilities Papers, Institute of Public Utilities, Michigan State Universities, 1987) pp. 3-13.

5/ Phillips Petroleum Co. v. Wisconsin, 347 U.S. 682 (1954).

1. On the supply side it imposed requirements that each pipeline company, before a certificate was issued to permit construction or to serve new markets from existing assets, was required to demonstrate that it had large, long-term reserves of gas under contract. These contracts were usually for 20 year terms. Such long-term contracts assured the LDCs served by the pipeline company that supplies were adequate to justify the local expense of shifting from coal gas or other fuels to natural gas. They also assured end users that investments made in gas-using equipment could be amortized over long periods.

2. On the demand side, the FPC strategy was to assure pipeline companies a market for their gas reserves by limiting access of competing pipeline companies to certificated end-use markets. To further strengthen each pipeline company's monopoly power, the FPC also approved tariffs that imposed minimum bills and, in some cases, sole supplier requirements on LDCs. Minimum bills effectively required LDCs to pay pipeline companies for their asset services whether or not gas was taken. In many cases minimum bills also required LDCs to pay the pipeline company for gas not taken. Sole supplier requirements gave preferred rates to an LDC that agreed not to purchase from another pipeline company.

There were four important consequences of this two-part regulatory strategy, a strategy which is not yet dead despite repeated efforts in the last four years to drive stakes through its heart.

First. The natural-monopoly powers inherent in the transportation of natural gas were strengthened by regulation and extended to create great monopoly powers over sales of the commodity. By creating this system of relatively strong monopolies, natural gas markets were balkanized. Price differences between two points could exceed, substantially, the cost of shipping gas between those two points since, often, the arbitrage mechanisms for reducing those differences existed only at the sufferance of pipeline companies, including the pipeline company with the relatively high price.

Second. Pipeline companies were placed at the planning center of the natural gas industry. Producers were denied direct access to LDCs and end users, and LDCs and end users were denied direct access to producers. Producers had to look to pipeline companies to market their gas, and LDCs and end users had to look to pipeline companies to assure themselves of adequate supplies.

Third. The risks of the producing and pipeline industries, including the risk of changing value of reserves, were effectively shifted downstream to end users by this regulatory structure. The combination of strong monopoly with powerful barriers to entry, minimum bills and sole supplier tariff provisions virtually guaranteed pipeline companies comfortable earnings on their assets. Federal regulation assured the ability to shift risks to LDCs, and Federal regulation through the Narragansett doctrine 6/ assured LDCs the ability to shift these risks forward to end users.

Fourth. The promotional regulatory system was almost universally acclaimed. Financiers liked the earnings assurances inherent in strong pipeline company monopolies, so they were willing to finance pipeline companies at low equity ratios. Producers desperately wanted pipeline companies constructed in order to sell by-product gas that was nearly worthless if sold near the field. LDCs found natural gas a much cheaper fuel than coal gas, and natural gas permitted them to displace coal in most major urban markets and expand their operations. The FPC liked the system, since the strong monopoly powers of pipeline companies permitted a highly judicialized decisionmaking process using traditional public utility regulatory methods. Consequently, politicians representing all these interests, liked the system also.

The system depended crucially on the abilities of pipeline companies which had failed to forecast correctly to sell gas to their customers at above market prices. Otherwise the risk accepted by the pipeline company could not have been passed downstream. In order to ensure that a pipeline company could sell gas at above market prices, it was necessary for the FERC to protect the monopoly power of the pipeline company. The principal ingredients for protecting the pipeline company monopoly were (1) tariff terms, especially tariff terms that allowed pipeline companies to deny transportation services to competitive gas merchants (which included producers and LDCs), and (2) FERC certification procedures.

Economists might argue about the unnecessary tying of transportation and sales, about the unnecessary monopsony power of pipeline companies in field markets, about the unnecessary monopoly power of pipeline companies in city-gate markets, and about the high costs of carrying unnecessarily large reserves, but with hindsight one must admit that the system worked well to move the system towards maturity. One prop under the system that made it work as well as it did was the fact that, before Phillips, wellhead prices were unregulated. Market forces might be distorted by monopsony power, monopoly power, and unnecessarily long-term, price-inflexible contracts, but they were not fully suppressed. Gas prices could still respond to demand and supply forces. Prices, therefore, could play their important equilibrating role.

6/ The Narragansett Electric Co. v. Burke, 381 A.2d 1358 (R.I. 1977), cert. denied 435 U.S. 972 (1978).

B. The natural gas system after Phillips.

The history of natural gas regulation between the 1954 Phillips decision and the NGPA can be treated briefly. The failure of the FPC to create wellhead prices sufficient to avoid a shortage, the demise of the FPC, the creation of the FERC, and the passage of the NGPA all make interesting chapters. We need not, however, dwell on them. What is essential for the current discussion is a recognition that many of the decisions made in that post-Phillips period are still with us, and they continue to influence the practices of LDCs, the FERC and pipeline companies. Two topics merit specific mention.

One. The political consensus that supported early FPC regulation broke down when the FPC, acting under the Phillips mandate, extended controls to wellhead prices. Many producers found regulation to be a severe constraint on their earnings, and consuming entities found their interests pitted against producers. The split spread to Congress, where the consuming states of California, the East, Northeast, and Upper Midwest were brought into conflict with the producing states of the Middle South, Southwest, and Plains. That conflict, as we all know, still influences natural gas debates in the Congress. 7/ The recent development of the Austin-Boston coalition is an encouraging sign that this regional conflict is dissolving under the common interest of producers and end users to induce an efficient transportation system.

Two. The system of Federal regulation in the post-Phillips period developed a certification quagmire. In order to control wellhead prices, and to control the flow of old vintage gas, the FPC evolved an unbelievably complex system of certification. The objectives were fairly straight forward: to ensure an "adequate supply" of gas to interstate markets and, almost equally difficult, to ensure that old vintage gas on which relatively low prices were imposed was not diverted from the particular interstate pipeline company to which it was assigned. 8/

The combination of a complex system of producer and pipeline certificate regulation evolved into a form of regulation where each departure from past practice required at least one new

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7/ This regional conflict is described in great detail in Elizabeth M. Sanders, The Regulation of Natural Gas: Policy and Politics, 1938-1978, (Temple University Press, Philadelphia, Pa., 1981).

8/ I say "assigned" rather than "contracted for" because even after the formal contract which committed the gas to the pipeline expired, the FPC/FERC required that the gas continue to flow according to the contract.

or amended certificate. This regulation by certification grew even more complex after shortages developed in the 1970s. Then it became necessary to categorize and prioritize end uses and end users of gas and to decide, in a certificate proceeding, who or what activity was entitled to gas, and if they were entitled, should they get the benefits of old vintage gas or only of new vintage gas. Obviously, this rigid system, where disputes tended to degenerate into a global benefit-cost analysis of the proposed action, whether it be a certificate proceeding or a rate case, made it impossible for timely decisions to occur.

Interim Summary. Before turning to the next, happier chapter in natural gas regulation, it is useful to summarize five key characteristics of the industry structure and regulatory system in place at the time of the passage of the NGPA:

1. The natural gas industry had reached maturity, and it consisted of pipeline companies and LDCs with strong monopoly powers. Consequently, highly balkanized markets existed at both wellheads and citygates. In effect, rather than a national market for gas with time and space arbitrage inducing efficient allocations of natural gas across space and time, the interstate system was, with many qualifications, a set of vertically integrated markets that were horizontally unintegrated.

2. A large proportion of natural gas was now found in a deliberate search for gas. That is, associated or by-product gas was not sufficient to meet demands, and non-associated gas production that was sensitive to selling prices was needed to fill the gap between demand and associated gas supply. Consequently, efficient wellhead prices had become crucially important for an efficient gas industry.

3. The increase in natural gas prices during the 1950s, 1960s and 1970s had increased the relative importance of pipeline companies' merchant-of-gas roles compared to their transportation roles. The incentive structure that regulators had created made losses more likely in the merchant role than in the transportation role, and, thereby, presented pipeline companies with strong reasons for using their monopoly powers over transportation to protect themselves from merchant losses, even at the expense of efficient operation of pipeline company assets.

4. The FERC evolved into a bureaucratic and heavily judicialized agency. All bureaucracies tend to be devoted to precedent, but quasi-judicial ones especially so. 9/

9/ Compare. "But when full allowance has been made for its undoubted merits, the fact remains that bureaucracy is liable to suffer from certain persistent maladies. Those of (continued...)

5. Economic efficiency never became an important objective of the FPC/FERC. In the early history of natural gas regulation, the FPC was promoting the development of the industry. After the industry matured, the FPC and the FERC largely reacted to external pressures -- pressures generated largely from past regulatory failures. In the 1970s, the FPC devoted most of its efforts to reacting to shortages, as in the 1980s the FERC has been reacting to deliverability surpluses and to the rigidity of regulations that support prices in the presence of such surpluses.

III. Natural Gas Regulation after the NGPA.

Before turning to the FERC's Order No. 436 -- that is, the FERC's attempt to escape the reactive mode and to structure industry and regulatory practices for a more competitive future -- it is useful to spend a few minutes briefly describing some consequences of the NGPA. These consequences conditioned and partially directed the policies enunciated in Order No. 436.

The NGPA was important for what it did explicitly and for some of its unanticipated consequences. It did two important things explicitly. First, it, in effect, reversed the *Phillips* decision and started a process of phased deregulation of wellhead prices for natural gas. As old gas was depleted and replaced by new gas, the wellhead market was to assume an increasing role in determining the price of natural gas. The NGPA, therefore, removed the FERC from the role of determining adequate price incentives for the production of optimal quantities of gas. As such a market for gas evolved, the legal and economic justification for much of the FERC's certificate regulation would disappear, most obviously with respect to producer/wellhead certification. Less obvious, but of equal importance, much of the certification regulation which was based on the need to

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9/(...continued)
most frequent occurrence are an excessive sense of self-importance on the part of officials or an undue idea of the importance of their offices; an indifference towards the feelings or the convenience of individual citizens; *an obsession with the binding and inflexible authority of departmental decisions, precedents, arrangements or forms, irrespective of how badly or with what injustice or hardship they may work in individual cases*; a mania for regulations and formal procedure; a preoccupation with particular units of administration and an inability to consider the government as a whole; a failure to recognize the relations between the governors and the governed as an essential part of the democratic process." (Emphasis added.) William A. Robson, *The Governors and the Governed*, (Louisiana State University Press, Baton Rouge, 1964.) p. 18.

allocate short supplies to end uses and end users by priority classifications also disappeared.

Secondly, the NGPA, by including self-implementing transportation authority under Section 311, opened a wide door for integrating state and national markets and for separating the transportation and merchant roles of interstate pipeline companies. In implementing Section 311, the Commission allowed certain transactions to go forward on a self-implementing basis without the detailed FERC review process that was customary in certification proceedings under Section 7 of the Natural Gas Act. The FERC implemented Section 311 in Order Nos. 30 10/ and 46, 11/ and expanded the scope of those rules in Order No. 436. 12/ In Order No. 60, the Commission also permitted interstate pipeline companies to transport natural gas on behalf of any other interstate pipeline companies. While the Congressional drafters of Section 311 probably had in mind the opportunity to tap abundant supplies in intrastate markets to providing supply-deficient interstate markets, the language they created was broad and it is permanent.

The important, unanticipated consequences of the NGPA came about when the 1982 recession occurred. The recession contributed significantly to the size of the deliverability bubble and led to falling gas and oil prices. Because of regulatory and contract rigidities, pipeline companies could not quickly lower their average prices, prices that had risen dramatically after passage of the NGPA as pipeline companies attempted to buy new gas to meet demands and to increase reserves. Since interstate pipeline companies had great abilities to protect certain of their markets from competition, their high prices in effect meant that spot gas in competitive markets had to be offered for lower than otherwise necessary in order to obtain an average price which was marketable. Big end users, resisting prices for gas charged by pipeline companies that exceeded fuel oil prices, demanded price discounts or transportation privileges in order to gain access to spot market gas. Since many big users had alternate fuel capacity, the pipeline companies had to meet these demands or lose such customers to fuel oil.

The FERC, responding to pipeline company requests and large end user bargaining power, approved several highly discriminatory programs to deal with this problem. Despite the patchwork nature of these programs, they were important in broadening and

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10/ 7 FERC 61,170.

11/ 9 FERC 61,224.

12/ 33 FERC 61,007, FERC Statutes and Regulations, 30,665.

deepening the spot market and in encouraging transportation rather than pipeline company sales. Many of these programs were merely straightforward discount sales programs to price-elastic markets. More important, however, were those programs that made it possible for end users to buy directly from producers and have pipeline companies carry third-party gas. Of the latter, Order No. 234-B and the Special Marketing Programs (SMPs) deserve special mention. Order No. 234-B was a temporary, experimental program that permitted pipeline companies to obtain blanket certificates to transport third-party gas to low priority end users. 13/ The SMPs permitted pipeline companies, producers and marketers to obtain certificates to transport and/or sell gas that was committed to a pipeline company, if the pipeline company released the gas. 14/

The problem with these programs was that they systematically discriminated against residential and commercial customers. While pipeline companies and producers were eager to implement and exploit these special programs in order to hold fuel-switchable customers on pipeline systems, they were not eager to permit customers with price-inelastic demands to gain such privileges. These captive customers were expected to remain tied to the old system so that pipeline companies could convey to them the high-cost gas contracted for before the deliverability surplus developed. Not only were these prices higher than the market would absorb if free purchasing were permitted, but in many cases these prices were indexed to rise despite falling demands. As late as January 1, 1985, many people were fearful that such indexing would push prices significantly upward despite a large and increasingly prolonged deliverability bubble.

The FERC attempted to increase opportunities for LDCs to gain access to spot markets and other relatively low priced gas

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13/ The Order No. 234-B (24 FERC 61,099) program was originally scheduled to expire on June 30, 1985. 24 FERC 61,099. The U.S. Court of Appeals for the District of Columbia Circuit in the Maryland People's Council Cases [MPC I] and [MPC II] ruled the program to be unduly discriminatory on May 10, 1985, but allowed the program to continue through October 12, 1985. Maryland People's Counsel v. FERC, 761 F.2d 786 (D.C. Cir. 1985) (MPC I); Maryland People's Counsel v. FERC, 761 F.2d 780 (D.C. Cir. 1985) (MPC II).

14/ The SMP programs were also experimental and expired on October 31, 1985, after the Court of Appeals for the District of Columbia Circuit in the MPC I and MPC II cases held the programs were unduly discriminatory.

by two actions: (1) in Order No. 380 15/ the FERC reduced somewhat the burden of minimum commodity bills by prohibiting pipeline companies from recovering variable costs in minimum bills for gas not taken, and (2) in its revised SMP orders, the FERC required pipeline companies participating in SMP programs to allow LDCs to nominate up to ten percent of their contract demands to be supplied through SMPs. Although Order No. 380 still required LDCs to pay minimum bills sufficiently large to cover pipeline companies' fixed costs, it did increase the ability of LDCs served by two or more pipeline companies to shift sources of supply. In so doing, LDCs somewhat increased competitive pressures on pipeline companies that encouraged them to renegotiate purchase contracts wherever possible.

IV. Adjusting the Regulatory System to the New Economics of Natural Gas: Order No. 436.

Some of the defects in the pre-Order No. 436 system regulation were mentioned in passing. Still, it should be useful to emphasize certain points even if some duplication is involved. The essence of natural monopoly regulation over the years has been ambiguity of purpose. In that respect, regulation of the natural gas industry had characteristics common to most public utility regulation, i.e., a hodgepodge of overlapping jurisdictions and conflicting objectives immersed in fact gathering and decisional procedures that are designed more to legitimize decisions than to make good ones. The gas industry differed from water, telephone, and electric utilities in that

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15/ Order No. 380 was the opening salvo in the Commission's attempts to enhance competition in the natural gas industry. That Order reduced the economic significance of pipeline company minimum bills by removing variable costs from such bills. Since 1984 the Commission, on a case-by-case basis, has been eliminating minimum bills entirely.

Order No. 380, Elimination of Variable Costs from Certain Natural Gas Pipelines Minimum Commodity Bill Provisions, Final Rule, Docket No. RM83-71-000 (Issued May 25, 1984). 49 Fed. Reg. 22,778 (June 1, 1985). FERC Stats. and Regs. ¶ 39,571. Order 380-A, Order Denying Rehearing and Granting in Part Application for Stay, July 30, 1984, 49 Fed. Reg. 31,259 (Aug. 6, 1984), FERC Stats. and Regs. ¶ 30,584, Order No. 380-B. Order Denying Rehearing Granting Clarification (October 24, 1984) 29 FERC ¶ 61,076. Order No. 380-C Order on Rehearing Reaffirming Application of Rule to Minimum Take Provisions and Denying Request for Waiver (October 24, 1984) 49 Fed. Reg. 43625 (October 31, 1984); FERC Stats. and Regs. ¶ 30,607 Order No. 380-D Order Denying Rehearing and Motion for Stay of Order No. 380-C (December 21, 1984) 29 FERC ¶ 61,332.

the conflicting objectives of the different regulators were more pronounced.

A. Some systemic results of the regulatory system.

While many unanticipated consequences developed from the interactions of conflicting objectives and multipurpose decision processes used in the regulatory system, only three will be mentioned. These three are the principal economic consequences which encouraged calls for reform:

1. Both PUCs and the FERC had rather consistent biases towards protecting and strengthening the monopoly power of LDCs and pipeline companies subject to their jurisdictions. Tariffs and certificate proceedings were tilted towards that end. LDCs and pipeline companies generally supported that objective, and procedural pressures on the FERC and the PUCs, pressures which forced a relatively strong emphasis on the financial wellbeing of firms under the jurisdiction of the regulatory bodies and a relatively weak emphasis on the financial wellbeing of competitors and customers, also supported that end. Relatively narrow proceedings, wherein the record was substantially under the control of the regulated firm, and which always emphasized the importance of jurisdictional firms but seldom describe the secondary, tertiary, and systemic consequences of agency actions, strengthened and supported this bias. This emphasis on the direct consequences of agency action and de-emphasis of the indirect consequences is quite naturally complemented by an anti-theoretical bias, since it is a key role of theoretical models to call attention to indirect consequences of policy actions, especially indirect actions that can often be counterintuitive.

2. The system of regulation created prices that were relatively insensitive to demand changes. The perceived need to control competition within the system, to police price discrimination by the monopolies which comprised the system, and for rate structure simplicity, when combined with requirements for elaborate proceedings before changing prices and/or price structures, tended to create price rigidity in the system. While certain procedures to gain price flexibility in response to supply forces had been incorporated in the system, e.g., PGAs and NGPA escalation provisions, the system was seriously deficient in mechanisms to change prices in response to demand forces, especially demand reductions. An important consequence of this lack of price flexibility was that demand fluctuations tended to be converted solely into quantity fluctuations rather than into a combination of quantity and price fluctuations as a competitive market would. Put differently, the price rigidity would not permit prices to adjust to the level of demand as it does in other markets. This, in turn, meant that gas tended to be overpriced in comparison to its free market competitors during

recessions and underpriced during economic booms. Consequently, pipeline and supply capacity had to be constructed to handle peak demands for a commodity which was underpriced in periods of economic expansion.

3. It is a condition of economic efficiency that price differences between two points in space for a given commodity shall not exceed the cost of transporting the commodity between the two points. The gas industry violated this standard of allocational efficiency continually. This inefficiency arose from three sources, wellhead vintaging with rolled-in pricing at the city-gate, rate-of-return regulation as applied, and tariff and certificate provisions which made interregional arbitraging almost impossible. It was vintaging (and the blocking of interregional arbitrage) which permitted a pipeline company to pay $7.00/Mcf for gas, incur a cost of $1.00/Mcf to ship it 500 miles, sell it at $4.00/Mcf, and make a profit. Such pricing practices clearly had adverse effects on the location of economic activity in the nation and on gas exploration and development decisions based on the misleading price signals passed to producers.

B. The incentive structure of pipeline companies.

The significance of these pre-Order No. 436 industry and regulatory characteristics can be highlighted by comparing the value added in the sectors of the natural gas industry in the 1960s with the value added in those sectors in 1982. 16/ In 1960, the wellhead price constituted 23.0 percent of the burner-tip price while LDCs contributed 43.5 percent of total value added. Pipeline companies contributed the remaining 33.5 percent. Ten years later, that is 1970, these numbers had changed little: the producers' share had increased from 23.0 to 26.8 percent, pipeline companies' share had fallen from 33.5 to 28.5 percent and LDCs share had risen from 43.5 to 44.8 percent. The 1970s brought large changes, however. The producers' share rose steadily. By 1978, when the NGPA was passed, producers' share was 41.4 percent and the pipeline companies' share had fallen to 25.7 percent. The LDCs' share had fallen to 33.9 percent. This trend continued into the 1980s. By 1982, the producers' share had increased to 55.1 percent and the pipeline

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16/ The statistics are taken from Table 9-5, "Average Gas Prices of Wellhead, City Gate, and End-User Level,: Gas Facts 1983: A Statistical Record of the Gas Utility Industry, American Gas Industry, Department of Statistics, 1984, p. 112.

companies' share had fallen to 25.0 percent. The LDCs' share had fallen even more; it was 19.1 percent. 17/

Contrast, again, the changes in prices between 1960 and 1982 and contemplate their significance for regulation. In 1960 the LDCs kept 43.5 percent of each dollar they received. In 1982 they kept 19.1 cents. Producers, on the other hand, received 23 cents of every dollar paid at the burner-tip in 1960 and 55.1 cents in 1982. Recall, further, that while the pipeline companies, in 1982, contributed approximately 25 percent of value added in the natural gas industry, the FERC does not regulate all pipeline companies. One estimate, floating at the FERC in 1984 and 1985 when Order No. 436 was being formulated, was that the pipeline companies regulated by the FERC contributed less than 15 percent of the value added by natural gas industry. That is a very small tail for the FERC to use to wag a dog as big as the natural gas industry.

Consider these large value added numbers for the producing sector in conjunction with the fact that a free market for gas means that gas prices in the future will probably correlate closely with oil prices and that oil prices will be determined in world markets, and probably will be unstable. This pattern of world oil prices will mean that whoever holds gas reserves will experience large, and relatively unpredictable, capital gains and losses. A question for regulators in 1985 was, and still is: Who should carry those risks, risks that are much larger than comparable ones were in the developing stages of the industry? Obviously, the appropriate place to start the search for an answer was with a clear recognition that someone must carry them; they are inevitable and unavoidable in the modern gas industry.

Contemplate for a moment the incentives that arise from these economic circumstances for pipeline company and LDC managers who have large merchant roles. The potential losses in that merchant role can easily be larger than the potential losses in the transportation role. Furthermore, regulatory practices that severely limited the likelihood of significant losses in the transportation role intensified that business reality. As a result, rational, profit-seeking pipeline companies and LDC managements were, and still are, presented with strong incentives to deliberately induce inefficient use in pipeline and LDC assets when doing so can protect their companies against significant losses from the merchant side of their activities.

The evolving economics of the natural gas industry rendered the risk allocation policies created by the FPC in the 1950s and

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17/ Recent years have seen a return to numbers similar to 1978, but the 1982 numbers are likely to be representative of the future of the industry when the bubble ends.

1960s unacceptable for the mature industry. Pipeline companies' rate designs, enforced by FPC/FERC supported monopoly power, that coerced end users to bear most of the exploration and production risk of producers could not be sustained. The risk of holding gas is much higher now than it was when the FPC/FERC pattern of risk allocation was developed. **Gas will not be an underpriced commodity in the future. Its price will move in response to international forces.** Allocation of exploration and production risks, therefore, must be freely negotiated. The FERC should facilitate the development of efficient gas markets that, in turn, facilitate that negotiation, but it should never allow its powers to be used to dictate that allocation.

Interim summary. Clearly, economic conditions in the natural gas industry in the early 1980s demanded changes in FERC regulatory objectives. Assuming that the nation had irrevocably decided to deregulate wellhead prices, possible objectives for regulating pipeline companies and LDCs fell on a continuum with monopoly organization emphasized at one end and monopoly elements subdued and enhanced competition emphasized at the other end. Since price competition between oil, coal, and gas and between gas and electricity was inescapable, the major debate was whether to encourage that competition and, in addition, encourage competition of gas on gas, or whether to use regulatory authority to suppress one or both forms of competition. In Order No. 436 the FERC chose to pursue the competitive solution.

C. Pipeline company and LDC incentive structures under Order No. 436.

Order No. 436 was intended to do several things that would foster efficiency objectives. The principal instrumental objective contemplated for pursuing efficiency objectives was intensified competition. Before turning to particulars, it is useful to describe those instrumental objectives in general terms.

First, by inducing pipeline companies to allow others to compete with them in their merchant roles, and removing minimum bills, it was expected that pipeline company incentives would be changed, and that pipeline company fortunes would be more closely tied to the transportation role and less tied to the merchant role. Second, by allowing others to use pipeline company assets to carry gas, horizontal markets would be created that complemented and disciplined the traditional vertical markets. Nationally-integrated spot and futures markets are two examples of desired horizontal markets.

One essential change that was expected to follow from the competitive forces released by Order No. 436 was a weakening of, or the elimination of, the mutual obligation of pipeline companies to sell gas and LDCs to buy gas in accordance with regulatory rules, except for price ceiling rules. Once these mutual obligations determined by regulation are weakened or removed, and it is not practically possible to remove one set without removing the other, many other changes were expected to inevitably follow. First, and most obvious, was that sole-supplier contracts and minimum bill tariffs at the citygate would end, and LDCs would have to assume responsibility for their own supplies. LDCs and PUCs would also have to make conscious decisions on the degree of security (or firmness of service) for which they would be willing to pay.

In order to meet obligations to satisfy demands of their end users, LDCs would find themselves encouraged to develop ties to more than one pipeline company and to exploit carriage obligations of pipeline companies so as to gain access to many gas suppliers. While it was expected that LDCs would find it in their interest to sign long-term contracts with suppliers, be they pipeline companies, producers or other LDCs, it was also expected that they would seek to retain enough flexibility in supply arrangements to avoid serious take-or-pay penalties during recessions. Perhaps LDCs would pursue contracts with enough price flexibility to permit substantial price reductions during recessions under this incentive structure. If they failed to do so, they would risk the loss of industrial customers in the next recession. In such bargaining, LDCs (and PUCs) could be forced to learn to rely upon markets rather than upon promises of pipeline companies and federal regulators for supply security.

With LDCs free to purchase gas from lowest priced sources, pipeline companies would be forced to bear the risk of their purchasing decisions at the wellhead and/or their building of peak shaving plants. Pipeline companies, under such circumstances, would be cautious in entering high take-or-pay contracts with producers. They would also be reluctant to accept definite or indefinite escalator clauses in their contracts. Such caution, it was hoped, would leave them sufficiently flexible to exploit low-priced gas during recessions. Consequently, demand decreases (increases) during future recessions (expansions) might be converted quickly into price decreases (increases) at both city-gates and wellheads.

Moreover, if pipeline companies and LDCs did not have mutual obligations to serve gas and be served gas, it was expected that rivalry between them would develop for industrial customers which are accessible to both. In such rivalry, pipeline companies have certain advantages, and those advantages would be enhanced if LDCs were completely dependent on pipeline companies for gas supplies. Clearly, as competition developed, LDCs would be required to give serious thought to what services they should offer to large customers which pipeline companies could not, and how the costs of those services could be kept competitive.

One important conclusion to be drawn from these arguments is one already drawn but worth repeating, namely, that demand fluctuations at the burner-tip might be transformed into both quantity and price fluctuations at citygates and at wellheads, rather than solely into quantity fluctuations as was formerly the case. This characteristic was expected to be attractive to both LDCs and PUCs, since it is probably a necessary condition for shifting risks upstream and for efficiently meeting market determined prices of competitive fuels.

V. Natural Gas Regulation Since Order No. 436.

Regulators have learned many painful lessons since Order No. 436 was issued. One thing they have learned is that the creation of efficient, competitive markets is not a simple task under the best of circumstances; an understanding of economics and political constraints is always needed. When the desired competitive market is for natural gas, and the producers and end users are, in large measure, separated by two regulated industries and two sets of regulators with incongruent objectives, the task is even more difficult. When the markets must be integrated across international boundaries, and even more regulated firms and regulators are involved, the challenge truly becomes immense. The immensity is dramatized by recognizing that profit seeking firms must be disciplined by structure and behavioral constraints to serve social purposes which are not necessarily their own.

Luckily, the task does not demand perfection. Efficiency gains have been made, and the status quo offers many opportunities for further gains. Moreover, the regulators involved have institutionalized interests to avoid gross economic inefficiencies. While the pursuit of efficient competitive gas markets may not top the list of regulators' objectives, the avoidance of gross inefficiencies is important to all.

As I survey the natural gas industry and the changing role of pipeline companies and LDCs in that industry, I conclude now, as I have many times in the last five years, that the single, most important component of the proper remedy for the current defects of competition is more competition. However, more competition, as necessary as it is, will not be a sufficient condition for an efficient industry. Pipeline companies and LDCs, in their transportation roles, will remain regulated for some time to come. Consequently, it is important that they be regulated in manners that facilitate efficient competition in gas at wellheads, city-gates and burner-tips, and that also induce constructive rivalry among and between pipeline companies and LDCs. In particular, regulated monopolies must not be permitted to leverage their monopoly powers into competitive advantages in nonregulated and potentially nonregulated activities in manners that reduce their incentives to make efficient use of their transportation assets or in manners that lower the efficiency of the natural gas industry, broadly defined.

As an example, it should be recognized that the crucially important problem of risk allocation has not been satisfactorily solved. Pipeline companies, for example, are aware that in a system of open access transportation they can lose sales rapidly. They, consequently, are reluctant to make the types of commitment to producers they made in the past. Current take-or-pay disputes are a constant reminder of the costs of forecasting failures. Moreover, they also know that it is not within the power of regulators, no matter how sympathetic they may be to pipeline company problems, to require dual-fuel customers (and customers with alternative sources of gas if such costs are not spread over all gas supplies) to pay for pipeline company contracting mistakes. Pipeline companies, no longer secure in the belief that they can shift the risks of long-term contracts downstream, are, not surprisingly, reluctant to enter into long-term contracts with producers which assign risks to the pipeline companies. Still, for many reasons, many pipeline companies are making it difficult for others to use pipeline company assets efficiently to gain access to long-term gas supplies.

LDCs, which under open-access transportation systems are invited to accept responsibility for their gas supplies, are, in many cases also reluctant to assume those risks. First, and frequently recognized, they are fearful that forecasting errors will mean losses to their stockholders as PUCs deny pass-through of the costs of such errors. LDCs, like pipeline companies, know that dual-fuel customers, (and even gas-only customers that might by-pass them) may be able to evade such costs even if PUCs allow their pass-through. Second, many of them are not yet convinced that the FERC will succeed in inducing pipeline companies to become nondiscriminatory transporters. Third, many LDCs are still paying contract demand fees to pipeline companies and interpreting those fees as rights to buy gas from pipeline companies. Consequently, they do not feel irresistible pressure to assume the heavy responsibilities of long-term gas portfolio planning.

The FERC's Order No. 436 was intended to induce the players, i.e., LDCs, pipeline companies, producers, large industrial companies, electric utilities and PUCs to confront this problem and seek an allocation of risk that was acceptable to all. The FERC, in Order No. 436, appreciating the magnitude of the problem and the deficiencies of federal regulators in making such decisions, said one thing emphatically: The FERC would not use Federal power to force LDCs to assume these risks. I believe the players can work out this problem, but I also believe that regulators should facilitate the process. I hope the FERC holds to its position that it will not use its power to impose such risks, but current signs of backsliding are in evidence.

FERC approval of the Texas Eastern settlement which created a deficiency-based GIC was, in my view, a major act of backsliding. 18/ It, in effect, reinstated a minimum bill for Texas Eastern, and, in so doing, may have allowed LDCs to invoke Federal authority to deny to PUCs the right to question the wisdom of the LDCs' pass-through of above-market costs that might result therefrom. Such backsliding tends to recreate the incentive structure that Order No. 436 attempted to remove. It, therefore, opens the unpleasant possibility of reliving the gas markets of the 1970s and 1980s.

The principal conclusion I must draw from the preceding analysis is that despite many minor failures by the FERC in implementing pro-competitive policies for the natural gas market, the FERC-led reforms, by responding to changes in the economics of the industry and the economics of industries producing competitive fuels, have facilitated the rejuvenation of the natural gas industry. The natural gas industry is much more competitive than it was 5 years ago. Pipeline monopoly and monopsony powers are minuscule compared to what they formerly were. Furthermore, that change is probably not reversible. All parties to this industry should adjust to the existence of competitive natural gas markets and seek to improve their efficiency. The FERC, in particular, should build on past successes by creating rate designs that improve the efficiency of competition. That objective should mold the choice of GICs. Progress towards Order Nos. 436/500 goals has been disappointedly slow, but time and experience have revealed the wisdom of those goals and of the need for renewed efforts to achieve them.

VI. The Importance of Pipeline Companies Rate Designs.

A. Unresolved structural problems.

Time does not allow a comprehensive survey of the many problems yet to be solved in order to complete the Order No. 436 initiatives. It is, however, worth mentioning three in order to demonstrate the types of problems remaining.

1. The take-or-pay problem has not yet been solved. While there are some reasons for believing that interim Order No. 500 has encouraged pipeline companies and producers to renegotiate a multitude of market insensitive contracts that hung over the industry in 1985, the cost to end users of that order is still

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18/ Texas Eastern Transmission Corporation, Order Approving Contested Offer of Settlement and Issuing Certificate, Docket No. RP87-177-044 through 046 and CP88-136-000 (Issued September 29, 1988).

not known, and that which is known is staggeringly large. 19/ Although Order No. 500, an Interim Order, is two years old, the debate on a permanent rule has not yet started among Commissioners.

2. The rate design reforms demanded in Order No. 436 have not yet been implemented. Current pipeline company rate designs do not reveal social costs and opportunities with sufficient precision to induce economically efficient actions from PUCs, LDCs, nonregulated pipeline company customers and producers. The need for seasonally differentiated rates was obvious. The order, consequently, called for seasonally differentiated rates and milage based rates. 20/ I am convinced, for example, that pipeline capacity during peak periods is seriously underpriced, and, conversely, during off-peak periods is overpriced. I am also convinced that pipeline company interruptible transportation services are overpriced during off-peak periods and that pipeline companies need more categories of transportation service, for example, quasi-firm and semi-firm services should be added.

The need for unbundling rates for pipeline company services and for reforming pipeline company transportation rates was emphasized in Order No. 436. Until the FERC creates rate designs that (1) clearly distinguish between asset services, i.e., transportation and storage services, and gas supply services, (2) efficiently prices pipeline and storage capacity, (3) efficiently prices gas services, and (4) presents LDCs with a menu of such services and prices, (including the terms under which the services are available), it will not be possible for LDCs to construct optimal gas supply and transportation portfolios.

3. An important complement to open access pipeline service is the right of firm customers of the pipeline company to periodically revise their contract demands (CDs). It cannot be anything but a major inefficiency to coerce a customer to continue to make payments for CD service which the customer does not want while denying that customer the right to sublease it and simultaneously denying this service to other customers. Yet that is exactly the policy the FERC has supported since AGD v.

19/ Order No. 500, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol: Interim Rule and Statement of Policy, Docket No. RM87-34-000. (Issued August 7, 1988) 40 FERC 61,172.

20/ "Any rate filed for service subject to this section must reasonably reflect any material variation in the cost of providing the service due to: (i) Whether the service is provided during a peak or an off-peak period; and (ii) The distance over which the transportation is provided." 18 CFR 284.7(d)(3).

FERC. 21/ Allowing a firm pipeline company customer to broker his capacity would ease this problem somewhat, but a customer who does not want that burden should not be required to carry it when CD reduction is a viable alternative. In Order No. 500 the Commission repromulgated most of the key parts of Order No. 436 but did not repromulgate the CD reduction program. I remain convinced that reviving, and perhaps revising, the CD reduction provisions of Order No. 436 should be an immediate objective for the FERC.

B. Important issues in rate design.

A general and a particular statement are useful in framing the pipeline company rate design issues before the FERC. First, in general, the objective of pipeline company rate design should be to provide service definitions and pricing signals to users of pipeline company services that encourage efficient behavior on their part, and to provide incentives to pipeline company managers to pursue efficient results. As suggested earlier, if buyers cannot create supply portfolios that reveal their interests, producers cannot judge the risks and rewards involved in producing new supplies.

Since the natural monopoly is in the pipeline assets, efficient behavior from pipeline company managers should be directed at efficient use of the pipeline and its complementary storage and gathering assets. Rate design should especially seek to avoid providing pipeline company managers with incentives to create inefficiencies in the use of pipeline company jurisdictional assets in order to pursue other company objectives. Second, in the particular circumstances of today's natural gas industry, rate design should encourage, facilitate and coerce the separation of the pipeline company's merchant-of-gas role from the pipeline company's transportation-of-gas role.

Another institution that is needed so that buyers and sellers can hedge risks is a viable futures market for natural gas. Futures markets are essential and natural adjuncts to competitive commodity markets. While few physical transactions are consummated under futures contracts, the price discovery that futures allow is key to fostering the accountability that disciplines markets. Furthermore, futures permit buyers and sellers of natural gas to select the degree of price risk appropriate to their individual circumstances. Risk sharing is an important part of the natural gas industry; LDCs, end users and producers would be beneficially served by an efficient

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21/ Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987), cert. denied sub nom. Interstate Natural Gas Ass'n v. FERC, 108 S.Ct. 1468 (1988).

futures market that allowed such hedging. The FERC should do all it can to aid the development of such a market.

The FERC, in promulgating Order Nos. 436/500 (and many other complementary orders) has committed the nation to rely on an interstate natural gas market for the production and allocation of natural gas. I believe the FERC, in so doing, was properly implementing the NGPA which initiated the phased deregulation of wellhead prices and encouraged the integration of intrastate and interstate natural gas markets and intrastate and interstate pipeline company transportation services. To gain the benefits of the NGPA, however, it is essential that the FERC use its regulatory powers over pipeline companies to ensure that the monopoly power inherent in pipeline transportation assets not be used to frustrate or distort the efficiencies potentially available in a competitive market for natural gas.

The success of Order No. 436 in reducing pipeline companies monopoly and monopsony powers, and, therefore, reducing pipeline companies' abilities to buy gas cheaper than competing merchants and to sell gas at higher prices than competitive merchants, was increasingly obvious by August 1987 when the Commission issued Order No. 500. 22/ Consequently, in Order No. 500 the Commission invited pipeline companies that intended to continue merchant functions to file GICs. GICs are now a subject overripe for consideration. GICs become crucially important for pipeline companies and for customers of a pipeline company's merchant role when the pipeline company loses its monopoly power in selling as and its monopsony power in buying gas.

Traditional FERC practice has been to honor the interpretation of CD charges of pipeline companies, not merely as rights to use the pipeline company's assets, but also as rights to demand that the pipeline company's merchant function provide gas up to the CD amount. Obviously, that tradition cannot be respected when the merchant and transportation functions of the

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22/ On August 7, 1987, the Commission issued Order No,. 500, which promulgated interim regulations in response to the Court's remand of Order No. 436. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 500, 52 Fed. Reg. 30,334 (Aug. 14, 1987), III *FERC Stats. & Regs.* ¶ 30,761 *extension granted*, Order No. 500-A, 52 Fed. Reg. 39,507 (Oct. 22, 1987), III *FERC Stats. & Regs.* ¶ 30,770, *modified*, Order No. 500-B, 52 Fed. Reg. 39,630 (Oct. 23, 1987), III *FERC Stats. & Regs.* ¶ 30,772, *modified further*, Order No. 500-C, 52 Fed. Reg. 48,986 (Dec. 29, 1987), III *FERC Stats. & Regs.* ¶ 30,786, and Order No. 500-D, 53 Fed. Reg. 8439 (Mar. 15, 1988), III *FERC Stats. & Regs.* ¶ 30,800 (Mar. 8, 1988) *reh'g denied*, Order No. 500-E, 43 FERC ¶ 61,234 (May 6, 1988).

pipeline company are separated. The CD charge is properly a charge for use of assets; it is not, and should not be, a payment for merchant activities. If there is, in certificates or in the law, an obligation of the pipeline company to sell gas on demand, such a valuable service should be priced separately from the transportation services of the pipeline company. The request for GIC proposals in Order No. 500 was a recognition of this principle.

So far, however, the Commission's request has not produced satisfactory results. Not surprisingly, many pipeline companies have proposed GICs that perpetuate the tie between their monopoly transportation services and their potentially competitive merchant services, ties that give the company's merchant services a competitive advantage over nonjurisdictional merchants. When designing GICs, the Commission should recognize the role GICs are expected to play in the natural gas industry. That role is not merely to require firm gas customers to accept certain risks associated with buying gas (pipeline company minimum bills did that) but to further the development of an efficient national gas market by giving LDCs and end users the ability to choose which merchant, or mix of merchants (including producers), each wants in order to meet its gas supply requirements.

C. Analysis of GICs.

Since proposed GICs fall into two well defined categories it is plausible to assert that in choosing a GIC design the Commission is choosing whether to use FERC powers to support further movement towards an efficient, North American market for natural gas or to use FERC powers to retard that movement. I do not believe the FERC any longer has the power to stop the forward movement, but it does have power to aggravate inefficiencies and slow progress. In my opinion "competitive price," or two-part merchant tariffs, appropriately defined, can make a significant contribution to efficient markets, and "deficiency-based" GICs, however defined, are unnecessary grants of monopoly power to pipeline company merchants that lead inevitably to gas markets less efficient than otherwise attainable.

Deficiency-based GICs are inferior to competitive-price GICs for four reasons:

1. They represent a tying arrangement between the natural monopoly of natural gas transportation and the potentially competitive commodity natural gas. Consequently, they perpetuate the necessity of regulation of a potentially market-disciplined commodity rather than facilitate the process of separating pipeline company monopoly and non-monopoly services.

2. They tend to "base-load" pipeline company merchant services and force competing merchants into a swing role. In a world

economy as unstable as the one in which the gas industry must expect to operate, recessions and expansions are inevitable. Consequently, the demand for natural gas will fall and rise in response to forces far larger than the industry, the FERC or the nation can control. A deficiency-based GIC acts, and is intended to act, to isolate the pipeline company merchant from that external instability. It does this by creating incentives for its customers to buy gas from the pipeline company merchant during depressed demand conditions, even when the pipeline merchant's prices are somewhat higher than those of competing merchants.

3. They tend to balkanize the natural gas market and create barriers to entry for competitive merchants, just as frequent flyer programs balkanize the air-passenger industry and create entry barriers to new airlines. If one pipeline company merchant can gain stability in an unstable economy with deficiency-based GICs, so can others. In fact, it is conceivable (but barely so), that nonregulated merchants might try deficiency-based GICs. All however cannot gain stability. One person can gain a better view at a football game by standing, but if all stand, the consequence is merely a loss of comfortable seats for all. Widespread use of deficiency-based GICs is similar to the advantage of standing, it is a gain for some at the expense of others, who when they respond with a similar tactic lower the benefits to all. An industry with widespread use of deficiency-based GICs would be a balkanized industry with customers largely tied to particular pipeline companies (and perhaps to some nonregulated merchants). While each gas merchant in such a balkanized market would, of necessity, fight to preserve its deficiency-based GIC to avoid becoming a swing supplier, the industry as a whole cannot escape demand fluctuations. The hot potato must end up somewhere.

4. They induce inefficient purchases of gas at times, and since the purchasers are largely LDCs who must resell at approximately the price at which they purchase, the inefficient prices are passed on to their customers. An efficient market will charge customers approximately the marginal social cost of gas. In a nationally competitive (i.e., nonbalkanized) market, the market will be the best estimate of that marginal social cost. Given the nature of the gas industry, and those industries producing directly competitive commodities, it is to be expected that under free market conditions, the price of gas, ceteris paribus, will rise when demand is growing rapidly and fall when demand is falling.

Efficiency demands that end users of gas be required to pay those market-induced relatively high prices when demand is growing rapidly and that end users be able to buy at those market-induced relatively low prices when demand is falling. To the extent that demand elasticities are non-zero, such pricing will moderate quantity fluctuations. Deficiency-based GICs interfere with efficient pricing to end users by sometimes requiring them to pay above market prices when demand is falling or not growing. Conversely, deficiency-based GICs may underprice gas to end users when demand is growing rapidly and competitive market prices are rising, because the deficiency-based GIC of a pipeline company merchant reflects past commodity costs.

An efficient gas market should be, and can be, a positive-sum game; all can benefit from its existence. Imposing, or allowing, pipeline company merchants to impose deficiency-based GICs in such a market constitutes a negative-sum game and lowers the potential benefits. Some may gain but the losses will exceed the gains.

Competitive-price GICs do not have the faults of deficiency-based GICs; they further the competitive objective of separating pipeline company transportation functions and prices from the pipeline company merchant functions and price. Consequently, they hasten the day when the price of natural gas as a commodity can be deregulated throughout interstate markets. They tend to keep pipeline company merchants on the same playing field with nonregulated gas merchants. They do not balkanize markets, and they tend to provide gas to end users at prices that are not merely correct on the average over time but correct at almost every point in time. Furthermore, competitive-price GICs have an advantage not explicitly recognized in the preceding analysis; namely, they encourage nonregulated gas merchants to adopt competitive-price GICs, and in so doing they will create a market determined fixed charge component in the two-part tariffs.

An issue often posed for regulators is whether competition is sufficiently intense to allow discretion in pricing to a regulated firm. A superior question, and one especially relevant in the GIC rate design, is whether the discretion will intensify or limit competition. Earlier it was argued that deficiency-based GICs limit competition by encouraging other merchants to adopt deficiency-based GICs. In contrast, a competitive-price GIC will intensify competition by encouraging other pipeline companies which are prevented from imposing deficiency-based GICs and nonregulated merchants to adopt competitive-price GICs. Rivalry will, therefore, lead to a market determination of the charge necessary to pay for the security of supply or "firmness of service" demanded by gas buyers.

The determination of the proper firmness-related GIC charge must await the development of a market for different degrees of firmness of service. I would approve almost any such charge and commodity price, or any set of such charges, if a pipeline company merchant wants to offer two or more grades of service 23/ (provided customers are free to abandon the pipeline company merchant for other merchants and free to reduce their CDs). The benefits of creating competition in this dimension of the market are worth the risk of some minor mispricing of grades of service.

Furthermore, I do not see the necessity of interim GICs. If only competitive-price GICs are to be accepted, I would accept permanent GICs now (provided again, that current customers are free to cease buying from the pipeline company merchants and free to reduce their CDs). I would reserve, however, the right for the FERC to review its cost-allocation practices so that both pipeline companies and their transportation and sales customers are on notice that transportation costs may rise or fall as the result of such a review.

D. Relative merits of competitive-priced and deficiency-based GICs.

It is a characteristic of competitive markets to generate prices that change over time. Competitive markets may produce efficient allocations and encourage efficient behavior by profit-seeking organizations, but they do not promise stable prices. Prices are an important equilibrating variable in markets. Attempts to stabilize prices tend to exaggerate instability in quantities sold, and attempts to stabilize quantities sold exaggerate instability in price. A promise of competitive markets is to produce the efficient mix of these two instabilities. The gas markets of the 1970s and 1980s are examples of what can be expected if prices are not allowed to adjust to market conditions.

A question confronting the FERC as it analyzes the relative merits of alternative GIC designs is how will they affect the stability of gas markets, and, especially, how will they affect particular participants in the gas industry. Two principles are useful to guide the analysis of these issues. First, in a competitive market all participants are essentially "price takers", i.e., each participant's ability to influence the price of gas is trivial. Second, if GICs are to affect the price of natural gas, either at particular points in time or on the average over time, it must be because they improve or lower the efficiency of the industry or they create some monopoly and/or monopsony power for some of the participants in the market.

23/ For example, one firm service might be a spot price for gas and x cents per Mcf/month for firmness, while a second firm service might be at spot price plus k cents for gas and (x - a) cents per Mcf/month for firmness.

From the earlier analysis, I conclude that deficiency-based GICs, if they become pervasive, should be expected to lower the efficiency of the trading system by balkanization of buyers and sellers. To the extent that this conclusion is correct, deficiency-based GICs would raise average prices to end users and lower them to producers to pay for the higher costs of inefficient trading in a less than fully competitive wholesale market. From the earlier analysis, I also conclude that deficiency-based GICs, if they became pervasive, might moderate price swings to end users over the business cycle. To the extent that the pipeline company merchant spends its revenues from the deficiency-based GIC to pay producers for gas not taken, the price to producers might also be moderated. That might not, however, be the result. Since an active spot market will continue, the result may be spot market fluctuations that are aggravated by the base-load nature of deficiency-based GICs, with producers receiving side payments during recessions. In this scenario, the difference between the price end users pay and producers get will widen in recessions and narrow in expansions.

Grounds for comparing the gross income of producers at different stages of the business cycle with and without a deficiency-based GIC are not apparent. The preceding analysis does, however, support the conclusion that any reduction in pricing instability will be accompanied by an increase in quantity instability.

A truism that must be made explicit is that economic improvement for some market participants can always be gained if those participants can gain some monopoly or monopsony power. Obviously, the losses to others will be greater than the gains to the monopolist/monopsonist. Since the pipeline companies are the only serious candidates for capturing such monopoly/monopsony powers, the question becomes, who is likely to gain if pipeline companies' monopoly/monopsony powers are restored? The answer to that may be deduced from the experience of the 1960s and 1970s; possibly the pipeline companies, probably no one, but those who control the FERC have the best chance. Since that lesson in regulation was reviewed earlier, it will not be repeated.

The likely consequences on industry participants of a competitive-priced GIC can be concisely deduced from the earlier analysis. By comparison with deficiency-based GICs, the competitive-based GICs will improve the efficiency of the wholesale trading system and consequently narrow the margin taken by middlemen, i.e., end user prices will fall and producer prices will rise, ceteris paribus. Where the deficiency-based GICs provided side payments to producers during periods of depressed demands, the competitive-priced GIC will provide such payment at all stages of the business cycle. Whether the total of such payments over the business cycle is greater from one GIC or the other is not apparent to me.

VII. Recapitulations and Conclusions.

Distilling the previous analysis permits the following conclusion: If the FERC cannot or does not limit the ability of LDCs and end users to select merchant(s) of gas, so that each pipeline company merchant must compete with nonregulated merchants, then long-term prices for gas, and the ratios of reserve to production will be essentially determined by the preferences of buyers selecting among the price and supply alternatives presented to them by producers, reflecting technological possibilities and the state of nature.

The decisions by the FERC embodied in Order Nos. 380, 436, 500, 509, et. al., taken in response to the NGPA and the Natural Gas Wellhead Decontrol Act, were based on the conclusion that a competitive market for natural gas that improved market communication between LDCs (and end users) and producers would induce the economically optimal prices, both long- and short-term, the optimal reserve/production ratios, the optimal exploration, and drilling incentives, and optimal use patterns. That conclusion is well supported by economic analysis and the history of unregulated intrastate gas markets. I believe that FERC regulatory policies pertaining to the natural gas industry should continue to reflect these conclusions.

The proper problem to be addressed is not whether long-term prices are satisfactory to a subset of industry participants, but whether there are market structures under the influence of the FERC that are limiting or distorting the ability of LDCs or end users or producers or traders from expressing their true preferences.

As I stated earlier and repeatedly, there are such structural distortions. The FERC's work is not done. It should reaffirm its commitment to the creation of a competitive, North American natural gas market and should regulate pipeline companies to facilitate the achievement of that objective. The correct cure for the current deficiencies in competition in natural gas markets is more competition. And more competition at this time means more choices for LDCs and end users, more unbundled rates and more efficient rate designs for pipeline companies' asset and merchant services.

The Commission has already delayed too long in imposing a competitive-priced GIC, and it has delayed too long in separating the pipeline companies' transportation and merchant roles, and it has delayed too long in coercing recalcitrant pipelines into nondiscriminatory open access, CD reduction programs and pipeline capacity brokering. In its attempts to proceed cautiously and not harm any major party directly, FERC has harmed all indirectly by lowering the efficiency of industry below that attainable.

Senator BINGAMAN. Thank you very much for that statement.

Next we will hear from Commissioner Charles Trabandt. We are pleased to have you here today.

STATEMENT OF CHARLES A. TRABANDT, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. TRABANDT. Thank you, Mr. Chairman.

I would summarize my prepared testimony by making four brief points.

First, I believe the concerns of the committee about the potential negative effects of the interim spot market GIC on the producing sector, as first expressed in Senator Domenici's letter of February 14 and the subsequent committee letters from you and others, are very well founded.

It is quite clear that the original objective last February was to link all pipeline sales to spot market prices and thereby drive down wellhead prices from the higher national average WACOG of about $2.30 to the range of the much lower spot market prices.

The policy objective of that intended ramp-down of wellhead prices was twofold. First, to ensure that pipeline sales would be price competitive in a market, then and now, dominated by 30-day spot market sales by non-pipeline competitors; and second, to ensure that there would not be any new buildup of take-or-pay exposure by interstate pipelines after the expiration of the Order Number 500 take-or-pay direct billing mechanism on March 31.

I would note that the spot market price reported today in the San Juan Basin is $1.53, which should be compared to the WACOG national average of $2.30.

Additionally, the extensive public comments in response to our proposed policy statement on GICs have demonstrated conclusively, in my judgement, that the proposed spot market GIC would have a serious negative effect on the producing sector and, indeed, the natural gas industry at large.

My prepared remarks discuss that testimony at length.

For that reason, there is widespread opposition to the spot market GIC from all sectors of the industry. On that basis, I believe it would be appropriate and proper for the Commission to abandon the spot market GIC concept in the proposed policy statement now.

Second, the public comments show that there is a broad consensus of customers, pipelines, producers and state regulatory authorities, that permanent GICs should be implemented on an expedited basis.

There is also general support for the proposition that the Commission should allow flexibility in the formulation of GICs, both interim and permanent.

Additionally, most parties support the use of the settlement process to facilitate the early adoption of GICs with broad participation of all interested parties, including independent producers.

There also is substantial support for the concept of a negotiated GIC rate, where an adequate competitive environment has been established.

I believe these general views in the record should guide the Commission in proceeding promptly to implement GICs on a case-by-case basis.

Third, it is quite obvious now that Commission action on GICs must be coupled with concurrent and meaningful action to create substantial competitive comparability between firm transportation options for the supply of gas to customers, on one hand, and traditional pipeline sales with a GIC, on the other.

That principle has become a virtual *sine qua non* for the nationwide implementation of gas inventory charges in the view of most non-pipeline commentators.

Thus, the Commission in GIC settlement proceedings, and through the pipeline rate design reform process now underway, must press vigorously and immediately for all of the necessary elements to establish, as soon as possible, at least that substantial comparability, if not complete competitive equivalency on every interstate pipeline in the nation.

Fourth and last, the transition of the natural gas industry to a more competitive and less regulated industry, in my judgement, is at a critical crossroad, as I describe in my prepared testimony.

I am reminded again by these hearings that there is no cookbook or bible to provide guidance to the Commission on this transition to a more competitive and less regulated industry.

While the Commission should, and certainly does, debate vigorously the inherent conflicts between abstract economic theory and practical reality—with varying degrees of pragmatism—the Commission, at all times, must keep its institutional eye on the ball, in athletic parlance.

For the natural gas industry, that means that the form of our policies must enhance drilling and exploration activities and must support longer-term contracts for production to assure future supplies.

In my judgement, the proposal of a spot market GIC has badly failed that fundamental requirement on both scores. I am firmly convinced that this subcommittee's oversight on this matter brought our attention back to the basics, so to speak, and hopefully helped us dodge another theoretical bullet. As a result, I respectfully encourage the subcommittee to maintain its vigorous oversight on these issues in the months ahead.

Thank you, Mr. Chairman. And I look forward to your questions.

[The prepared statement of Mr. Trabandt follows:]

TESTIMONY OF

COMMISSIONER
CHARLES A. TRABANDT
FEDERAL ENERGY REGULATORY COMMISSION

BEFORE

THE SUBCOMMITTEE ON MINERAL RESOURCES
DEVELOPMENT AND PRODUCTION
OF THE
COMMITTEE ON ENERGY AND
NATURAL RESOURCES

UNITED STATES SENATE

SEPTEMBER 14, 1989

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to testify today at this oversight hearing to examine the potential producing sector impacts of the Federal Energy Regulatory Commission's proposed policy statement on interim gas inventory charges (GICs) in Docket No. PL89-1-000 and the implementation of permanent GICs. 47 FERC ¶ 61,294 (1989).

Before addressing the specific subject of this oversight hearing, I would like to take this opportunity to congratulate the Committee on the enactment of the Natural Gas Wellhead Decontrol Act of 1989. Enactment of that legislation is a crucial step in the creation of a permanent competitive natural gas industry and market for the United States. Enactment also represents the culmination of many years of concerted effort by the Members of this Committee to remove Federal price controls from the production of natural gas. The Committee deserves great credit for its success.

Turning now to the subject of this hearing, I want to thank Chairman Bingaman, Senator Domenici, Senator Nickles, Senator McClure and Senator Wallop for the several letters expressing serious concern about these issues over the past seven months. I believe those letters have provided a critical and much needed focus on the potential negative impacts of certain GIC proposals on the natural gas producing sector during the Commission's deliberations on the GIC concept. The Subcommittee's continued, vigorous oversight of these matters in the months ahead should serve to ensure that the Commission carefully considers and balances appropriately any such potential negative impacts in the formulation of a GIC policy, as well as in other pending natural gas policies. Such oversight, in my judgment, is particularly necessary at this juncture of the transition to a competitive natural gas industry.

I believe that that transition is at an important crossroads in the evolution from the traditional structure of the natural gas industry and the Commission's past regulatory policy. Thus far, there have been a number of positive steps in that evolution. For example, almost all interstate pipelines are now operating with blanket certificates for nondiscriminatory open-access transportation service. Latest figures indicate that over 75% of the interstate pipeline throughput is now in the form of such transportation, with a corresponding decrease in traditional pipeline sales. The resolution of almost all past accrued pipeline take-or-pay exposure under old wellhead contracts has been achieved by voluntary renegotiation and, in many cases, global settlements of the broader business relationships and problems between producers and pipelines. Increasing proportions of natural gas wellhead sales occur under market-responsive contracts and large quantities of natural gas have been released to the national market from prior dedication to pipeline system supply. A significant amount of so-called "old gas" has been rendered subject to market prices and, as a result, enhanced production. Critically needed additional pipeline capacity is being provided to the Northeast, California, and the Gulf Coast

OCS on a timely basis. And, there has been a virtual rush of new and vigorous gas to gas competition and competitors on virtually every pipeline system on-shore and off-shore across the country, albeit subject to the continued need for deterrence of undue preferences for pipeline affiliates.

At the same time, the evolution still has not reached a more general, nationwide state of workable competition of a more permanent nature. For example, the bulk of the non-pipeline sales today are 30-day spot market contracts, although an increasing percentage of such sales in some markets are under contracts with terms in excess of 30 days. The vast majority of the transportation services are interruptible, rather than firm, and also are based on 30 day service contracts. There is no generally accepted procedure for capacity reassignment. The nature of the relatively small percentage of firm transportation contracts is decidedly not comparable in many important respects to the transportation element of bundled pipeline sales service. There is no general access across the industry to unbundled pipeline storage and other critical supporting services. Customer conversions from firm sales to firm transportation have not proceeded in any significant amount because of that lack of comparability and certain regulatory limitations on the duration of firm transportation service. Pipeline rate design largely reflects traditional regulatory concepts now out of date and badly in need of reform to reflect a competitive market. As a result, there is no foundation in fact for any assertion that the transition is already all but completed. Quite the contrary, while significant strides clearly have been made, there is still a great distance to go to establish that permanent and workable competition across the interstate natural gas pipeline industry.

It is in that more general context that the current debate about interim and permanent GIC's should be reviewed. The Commission and the industry today face a set of regulatory issues and decisions which could either (1) facilitate directly more permanent and more workable competition, on one hand, or, in the alternative, (2) chill in large measure the degree of current competition and otherwise impact negatively various sectors of the industry increasingly dependent upon such competition in lieu of pipeline monopoly power. That is the substantial challenge which confronts the Commission today more generally and specifically in the area of interim and permanent GICs. That also is the reason why I believe continued, vigorous oversight of the Commission's regulatory initiatives by this Subcommittee would be appropriate.

A brief historical note also may be in order at this point. I recorded in detail my views on the various proposals and issues included in the proposed policy statement in an extensive concurring opinion issued with that statement on May 30, 1989. In that opinion, I discussed at some length the background and events which led finally to the issuance of the proposed policy statement at the end of May. For the convenience of the Subcommittee, I have attached a copy of that concurring opinion to this testimony. It may be useful to summarize briefly that background discussion this morning.

The proposed policy statement included two primary proposals for an interim GIC. A "competitive price" proposal was based on the use of spot market prices to set pipeline sales rates. A "deficiency charge" method was based on a pipeline's weighted average cost of gas (WACOG) and a customers's purchase deficiencies below a specified level of nominated purchases. The Commission also sought comment on a possible generic alternative involving a flat charge set for specified purchase deficiencies. The key analytical factor for this discussion is that the initial proposal of the competitive price, or spot market, interim GIC concept in February of this year was the triggering event, which led to the eventual issuance of the May proposed policy statement. And, as originally proposed in February and later incorporated in the proposed policy statement, the spot market interim GIC was intended to link all pipeline sales to spot market prices and, thereby, drive down wellhead prices from the significantly higher national average WACOG of about $2.30 to the much lower spot prices, as I chronicle in my concurring opinion. The policy objective of the intended rampdown of wellhead prices was twofold: first, to ensure that pipeline sales would be price competitive in a market then and now dominated by spot market sales by other competitors, and second, to ensure that there would not be any new buildup of take-or-pay exposure by pipelines after the expiration in March, 1989, of the direct billing program for take-or-pay payments under Order No. 500.

In a nutshell, the proposed policy statement as a procedural vehicle is a direct manifestation of the vigorous debate within the Commission about the advisability of such a spot market proposal. And, the "deficiency charge" method and the "flat charge" alternative represent concepts developed specifically to provide substantive options to the spot market proposal for analysis and public comment. Also, the letters from Members of this Committee, beginning with Senator Domenici's letter of February 14, 1989, were understandably strong reactions expressing serious concern about that spot market interim GIC concept.

My views on the various proposals included in the proposed policy statement were recorded in the concurring opinion. Insofar as potential negative impacts on the producing sector, the concurring opinion highlighted my serious concern about spot market GICs and the devastating effect a rampdown of wellhead prices would have on drilling, exploration, development and production of additional deliverability to meet growing demand on a timely basis. I also expressed the view that wellhead contracts with terms longer than 30 days, as well as prices other than spot prices, were essential for increased drilling, exploration and development. Additionally, I took the position that the Commission has an affirmative responsibility to encourage such longer term contracting at this point in the transition in order to ensure better a reliable and adequate supply of natural gas in the future. Finally, I made clear that the Commission should proceed to consider GIC options on a case by case basis and not adopt any specific spot market GIC concept as a generic model or "cookie cutter."

At the same time, there have been substantial indications over the past year that many pipeline customers have pursued a least cost purchasing practice that involves "baseloading" on lower price spot market gas, while still retaining the contractual right to demand full contract sales volumes from a pipeline supplier, in the absence of some form of GIC. Thus, pipelines could be placed in the potentially untenable position of retaining sufficient reserves to meet the full contracted demand volume levels, with attendant take-or-pay exposure and difficulty in managing "must-take" gas operations. The only other viable alternative would be to shed a portion of those reserves which exceed the low average sales resulting from customers "baseloading" on spot gas, leaving the pipeline with inadequate reserves to meet peak load demand when the customers "swing" back onto pipeline sales, as occurred last winter. These factors led me to opine that the Commission faced a fundamental dilemma of trying to proceed expeditiously to implement some form of GIC on an interim basis (which argued for a rigid "cookie cutter" formulation), while allowing at the same time for consideration of various conceptual GIC forms (which could involve the same procedural and substantive complexities that have delayed many permanent GIC proceedings).

The Commission is now reviewing the initial and reply comments to the proposed policy statement filed, respectively, on July 14, 1989, and August 14, 1989. Those comments provide the first extensive generic record on these issues, since April, 1988. Thus, the comments provide a timely and critically needed review of the current state of the natural gas industry and the potential role of interim and permanent GICs. While a detailed analysis of the comments is still in progress, my own review leads to several significant conclusions.

First, there appears to be a broad consensus of customers, pipelines and producers that permanent GICs should be implemented on an expedited basis. Second, there is a general consensus that the Commission should provide significant flexibility in the formulation of interim GICs, rather than the rigid "cookie cutter" options, where needed to bridge the period during which a permanent GIC is under negotiation and subsequent review by the Commission. There also is substantial support for the use of the settlement process to facilitate the early adoption of GICs, both interim and permanent, with broad participation of all interested parties. Similarly, there is considerable support for the notion of a negotiated interim GIC rate. Producers, customers, state regulators and marketers emphasized strongly that action on GICs must be coupled with concurrent and meaningful action to implement substantial competitive comparability between firm transportation services and those features of pipeline system supply sales. The majority of the comments support the need for interim GICs tailored to specific pipeline situations within the framework of a relatively consistent set of general principles. Although there is a predictable and understandably wide variation in views on the specific details incorporated in the proposed policy statement, there appears to be general support from almost all commenters for prompt, measured and appropriate action to implement permanent GICs and, where needed, some form of interim GIC.

With regard to the two specific options in the proposed policy statement, there appears to be widespread opposition to the spot market-based demand concept. There also is some concern about potential anti-competitive impacts of the deficiency-based concept in the context of the current status of the transition, with virtually no comparable firm transportation available for competition with pipeline sales. A number of alternative proposals of various kinds were submitted in the comments. One potentially interesting "pro-competitive compromise alternative" was developed by Professor Cicchetti and his colleagues at the Energy and Environmental Policy Center, Kennedy School of Government, Harvard University. That particular alternative emphasizes the preservation and enhancement of short-run competition and uses both the WACOG and spot market prices with nominated volumes and actual takes to calculate the interim GIC charge. On balance, I believe that the public comments have demonstrated beyond any reasonable doubt the wisdom of not adopting the spot market IGIC proposal as a "cookie cutter" for general application across the country. Also, the concerns expressed about the potentially anti-competitive features of the deficiency based method deserve careful consideration in individual cases.

It may be useful to focus more specifically on some of the comments addressing the spot market interim GIC, in light of the Subcommittee's concerns. A group of nine producer and royalty owner associations, including the Independent Petroleum Association of America, opposed spot market pricing, because the spot market is relatively new and lacks maturity. They emphasized that the spot market is based on a current over-supply of natural gas and is based largely on 30 day interruptible transportation and sales contracts, reflecting the lowest priced competitive alternatives. Thus, they believe spot market pricing would lead to a circularity of pricing that would ramp down wellhead prices to the detriment of the development of replacement reserves, because producers would be denied sufficient capital to undertake needed exploration and drilling. They also asserted that spot market pricing would be functionally equivalent to "backdoor" regulation of wellhead prices in violation of Section 601 of the Natural Gas Policy Act. They were joined in the latter concern by the Petrochemical Energy Group. Also, the Natural Gas Supply Association, while not opposing a demand based GIC per se, called for the Commission to make clear that any GIC tied to spot prices would not trigger the exercise by pipelines of "FERC-out" or "market-out" clauses in current contracts.

Exxon argued that the Commission should not adopt a spot market "cookie cutter" interim GIC, nor attempt to dictate any particular form of GIC for a pipeline, preferring instead a negotiated rate where there was a truly competitive environment and a form of cost based rate when there wasn't. Exxon contended that spot prices do not equate generally to the commodity portion of the long-term gas price because of inherent differences in the two markets, and it is a mistake to presume that the spot prices reflect the supply security element of a longer-term contract. Exxon postulated a four criteria test to determine if a pipeline system was adequately competitive to permit a market-based GIC developed through pipeline-customer negotiations. Where there was not adequate competition, Exxon proposed a cost of service-type of methodology that would reimburse the pipeline's costs of providing the customers' nominated level of supply in the event of a minimum level of aggregate takes.

Mobil Natural Gas Company was more supportive of a demand based interim GIC which used spot market prices in the calculation, but with a demand charge element based directly on the pipeline's estimate of the additional expenses for the supply to meet nominated levels of sales service. Mobil asserted that the use of spot market prices in that form of a two-part charge would avoid the potential for any ramp down of wellhead prices, because the demand charge would be derived directly from the projected WACOG to meet nominated demand. In combination, the two parts of the charge would address the commodity value and long term security aspects of longer term contracts included in the WACOG, including their market responsive features.

Other producers and marketers variously emphasized in differing degrees similar concerns with the potential negative impact of spot market pricing, the potential anti-competitive effects of the deficiency based option, and the extreme need for substantial comparability, if not full equivalency, of firm transportation with pipelines sales features as a condition precedent to implementing the interim GIC proposals. Generally, there was widespread support for a flexible approach to any interim GIC, but with considerable emphasis on the comparability issue and establishment of competitive parity between pipeline merchants and other non-affiliated suppliers. These points emphasized further the crossroads status of the transition discussed earlier.

Several distributor comments are of interest in the context of the Subcommittee's concerns. The Northern Distributor Group, which includes 15 of Northern Natural Pipeline's larger distribution customers, expressed the concern that the spot market interim GIC could create a potential for manipulation and serious market disruptions, because the spot market pricing will inhibit more rational pricing of longer term supplies. If long term prices are thus tied directly to the spot price, the indexes will reflect a much smaller number of non-indexed contracts, leading to wide price swings and inherent instability in the market. Southern California Gas Company opposed the spot market pricing concept, because it would depend on the assumption that long term prices inevitably exceed spot prices. That assumption according to SoCal, will not necessarily be accurate when the supply-demand balance is restored, most gas is under longer term contracts, and spot gas may command a premium. Atlanta Gas Light Company opposed spot market pricing, because spot prices are volatile and unpredictable, and the GIC would be unstable as a result.

The aforementioned comments demonstrate well that the spot market interim GIC included in the proposed policy statement would introduce an unjustified degree of risk for the producing sector, and indeed the natural gas industry and the natural gas consumer. The potential of significant negative impacts, and even the devastating effect I discussed in my concurring opinion, is evident on the face of the record in the proposed policy statement proceeding. Consequently, I would submit that the understandable concerns of the Subcommittee have been validated materially and conclusively by the industry-wide public comments. On that basis, I believe that it would be appropriate and proper for the Commission to abandon completely the spot market interim GIC concept included in the proposed policy statement and move on to other, far more defensible approaches to interim GICs, where necessary, and permanent GICs.

Before concluding, I would like to mention briefly several other recent developments that bear on these issues. First, the Commission on July 19, 1989, rejected a proposed settlement of express interest to the Subcommittee filed by Transcontinental Gas Pipe Line Corporation, that incorporated a form of spot market pricing somewhat different from the proposed policy statement. One of the several major concerns about that settlement that led to opposition was the spot market pricing, as raised by the Producer Associations. Another concern was the relative level of comparability between firm transportation and pipeline-affiliated sales. On August 25, 1989, the Producer Associations, Transco, and Sales Customers filed joint comments reflecting their agreement to support a modification to the renegotiated and refiled settlement in the nature of a compromise. Transco expressly agreed that the settlement provides no basis for the abrogation of contracts with existing producers or for the exercise of "FERC-out" clauses, market out clauses, or other such provisions. Additionally, the commodity prices will be negotiated between Transco and its sales customers pursuant to a procedure consistent with section 601 of the NGPA, that avoids any possibility that the prices per se would be deemed to be the "just and reasonable" prices. Also, the renegotiated and refiled settlement contains some features which purportedly will improve the comparability of the firm transportation services be provided by Transco. The refiled settlement is now under review by the Commission staff.

Second, the Commission on June 30, 1989, with Commissioner Langdon and I dissenting, adopted an interim rate proposal of Panhandle Eastern Pipe Line Company that incorporated a form of spot market pricing and some features of an interim GIC-type mechanism. That action was protested vigorously by some industrial and producer intervenors as largely inconsistent with many of the principles associated with competitive parity in the proposed policy statement. As the Subcommittee has noted, that decision was tantamount to adoption of spot market pricing, albeit without any pro-competitive features, while public comments on the proposed policy statement were being filed and reviewed. My opposition to the Panhandle rate filing reflected all of those protests.

Third, the Commission has completed rehearing on the Rate Design Policy Statement issued on May 30, 1989. Many of the provisions included in that Policy Statement could materially enhance the competitive parity of non-affiliated merchants using firm transportation and unbundled services, while reforming pipeline sales rate design (apart from the GIC) in a manner that would reflect better the new competitive environment. At the same time, however, there are other features, such as the treatment of discounted volumes, which could be contrary to that result. Since the policy statement must be implemented on a case by case basis, the real decisionmaking for specific pipelines will occur in pending and future rate cases. For example, the Commission already has decided a Consolidated Natural Gas case, where the pipeline will in all likelihood be subsidized for its selective discounting of interruptible transportation rates in a manner directly contrary to Commission regulations under Order No. 436 and completely inconsistent with the goal of competitive parity. Thus, the Commission still must demonstrate in its actions the promise of competitive parity espoused in the words of the Rate Design Policy Statement.

Fourth, one of the recurring themes in the public comments in the interim GIC proposed policy statement is the urgent need to amend the Commission's regulations under Order No. 436/500 with regard to the duration of firm transportation services. Under those regulations, when a sales customer converts from firm sales to firm transportation, the duration of that new firm transportation service will be governed only by the length of the contract, and not by regulations under the Natural Gas Act. That result under the Order No. 436/500 regulations is generally recognized and acknowledged now as a fundamental, practical bar to any extensive conversions to firm transportation. It is clear that, by whatever procedural mechanism, the Commission should amend the regulation to restore normal NGA treatment. I would note that most producers now support such an amendment to facilitate expedited conversions by distributors to firm transportation. Commissioner Stalon and I have urged that such action be taken for some time.

Fifth, the Commission last month finally adopted a form of capacity assignment on the Texas Eastern system, which should break the several year logjam on this issue. Texas Eastern Transmission Corporation, 48 FERC ¶ 61,248 (Aug. 22, 1989). Previously, the Commission has issued a Notice of Proposed Rulemaking on capacity brokering and approved a so-called capacity brokering experiment on the United Gas Pipeline system. Neither of those initiatives thus far has led to any meaningful or generally applicable assignment or re-allocation of contracted pipeline capacity. I am optimistic that the new program on Texas Eastern will provide needed experience and the foundation for similar programs across the country that would enhance materially competitive opportunities.

Sixth, the Commission in July also approved the compliance filings necessary to implement previously approved GIC proposals on the Texas Eastern system serving the Northeast and the Transwestern system serving California. The Texas Eastern GIC is deficiency based, while the Transwestern GIC is market based. Each of these concepts reflect particular and, in some respects, unique features on those two systems. It is anticipated that the two GICs may be operational this fall for the respective service areas. Thus, the extensive debate which has occasioned the GIC issue since Order No. 500 was issued in August, 1977, will now be replaced in part with actual experience for the industry, the Commission and the Congress.

Of course, many other pending matters have, and will continue, to bear on the pace and the progress of the transition to a less regulated, more competitive industry and a stronger natural gas market. Natural gas futures contracts, Canadian imports, industrial by-pass, court decisions, and other important matters will have a decided effect on the transition now underway. Time does not allow any detailed discussion of those other pending matters, but they should be noted in passing as further elements in the evolution to the competitive industry.

Finally, let me conclude with an observation about the Subcommittee's concerns. As has been, and still is, quite clear about these transitions of less regulated industries, there is no "cook book" or "bible" to provide guidance. Similarly, unconstrained adherence to abstract economic theory, or even economic theory focused for a particular, partially regulated application, can lead to counter productive results. On a continuing basis, the Commission debates vigorously the inherent conflicts between theory and practical reality, with varying degrees of pragmatism. Nevertheless, there are certain fundamental factors, such as the need to enhance drilling and exploration activities to assure future supplies, that remain essential to any proposal for further transition. Similarly, the Commission must keep its attention focused on the specific competitive impacts of its decisions on the parity of competition between sales and firm transportation.

In a sense, the Commission then must make sure that "it keeps its eye on the ball", in athletic parlance, and does not become lost in the details of the moment nor mesmerized by theoretical exigencies. With regard tc the spot market interim

GIC, I am firmly convinced that the Subcommittee's continued oversight since last February has helped the Commission dodge another theoretical bullet and appropriately brought our attention back to the basics. As a result, I encourage the Subcommittee to maintain its vigorous oversight in the months ahead.

Thank you, Mr. Chairman.

ATTACHMENT

Interim Gas Supply Charges) Docket No. PL89-1-000
And Interim Gas Inventory Charges)

(Issued May 30, 1989)

Trabandt, Commissioner, concurring:

I concur in the issuance of this Notice of Proposed Policy Statement (PPS) on the subject of Interim Gas Inventory Charges (IGIC) with a major reservation about the spot market IGIC option and several observations.

1. Background

I believe it may be helpful to review briefly the history of this PPS in the context of the Commission's consideration of the GIC and IGIC issue over the course of the past five months. That history may provide some useful perspective for the development of public comments.

The PPS has its seeds in the Commission's debate at the February 15, 1989, Commission Meeting on Transcontinental Gas Pipe Line Corporation's (Transco) proposal of a GIC in Docket No. CP88-391-001. The Transco proposal involved a form of GIC which incorporated a price formula keyed to Gulf Coast spot market prices and was dependent upon a Commission finding that Transco's relevant market was sufficiently competitive. As a result, the Commission staff proposal was to set the Transco proposal for hearing on the competition issue, which the Commission eventually did in its order of March 24, 1989, in that docket (46 FERC ¶ 61,364 (1989)). Ostensibly because the hearing on the competitive issue and related matters was going to require an extended period of time, the Commission staff also proposed that the Commission *sua sponte* issue Transco a two-year IGIC certificate. The two-year IGIC certificate included a markedly different form of GIC, although it also had a formula keyed to spot market prices.

A majority of the Commission opposed the two-year IGIC certificate on a variety of procedural and substantive grounds. While the concept of an IGIC had some potential benefit, because of the lengthy evidentiary hearings then deemed necessary for market priced GIC proposals, there also were serious questions about the spot market IGIC and related matters. The Commission, as a result, discussed the possibility of a proposed policy statement on IGICs for public comment at the February 15 meeting. Immediately thereafter, the Commission staff prepared a proposed policy statement which included only the two-year spot market IGIC originally proposed for Transco. Again, a majority of the

Commission was unwilling to support a proposed policy with just that option. The instant order is the product of the debate since February. Of note, this PPS now contains two primary options and several other concepts for an IGIC.

During this same time frame, and not coincidentally, the Commission completed rehearing on the Texas Eastern Transmission Corporation settlement in Docket Nos. RP85-177-057 and CP88-136-002, which involved an extended debate and a 3-2 vote (with Chairman Hesse and Commissioner Stalon dissenting) on the deficiency based GIC in the settlement. The Commission also revisited the Transco hearing issue and decided in its order of May 23, 1989 (47 FERC ¶ 61,244 (1989)), in the same certificate docket to hold in abeyance the hearing, pending completion of a written submission approach first adopted in El Paso Natural Gas Company, Docket Nos. CP88-434-000 and RP88-185-000, issued April 27, 1989 (47 FERC ¶ 61,108 (1989)). In El Paso, the Commission concluded that a more appropriate and expeditious procedure was to resolve the issues relating to market competition on the basis of written information submitted directly to the Commission, rather than to proceed at the outset with an undoubtedly lengthy formal hearing before an administrative law judge. Other issues would be addressed after the Commission first resolves the competition issues on the basis of written submission. Contemporaneously with the second Transco order, the Commission also adopted the written submission approach for further consideration of a market pricing GIC proposed by Tennessee Gas Pipeline in Docket Nos. CP89-470-000, et al., issued on May 23, 1989. (47 FERC ¶ 61,245 (1989)).

Also, during the consideration of the PPS and the aforementioned related dockets, the Commission received various proposals and comments on the subject of the IGIC from, among others, the American Gas Association (letter of April 14, 1989), Interstate Natural Gas Association of America (letter of April 19, 1988), Pennzoil Exploration and Production Company (letter of March 16, 1989), Senator Pete V. Domenici (letter of February 14, 1989), and Senators James A. McClure, Don Nickles, Malcolm Wallop and Jeff Bingaman (letter of March 13, 1989). Finally, in the latter stages of our consideration of this PPS, the Commission also has been debating the substance of the pending Policy Statement Providing Guidance With Respect to the Designing of Rates in Black Marlin Pipe Line Company, et al., Docket Nos. RP89-75-000, et al. and PL89-2-000. The rate design policy statement, in my judgment, has several aspects which are directly relevant to, and may bear on, the analysis of the IGIC concepts in this PPS. I mention these various materials, because they may provide some assistance for interested parties in developing

public comments in this docket and also because they have been considered informally in fashioning the instant PPS.

2. The Central Issue

The Commission faces a fundamental dilemma in its consideration of an IGIC concept as part of the drive under Order No. 500 to implement GIC-type rates across the country. The basic notion of an IGIC is analytically attractive as a bridging mechanism to a permanent GIC for a given pipeline, which generally has taken, for a variety of management, procedural and substantive reasons, an extended period of time to reach approval. There, however, may be little merit in an IGIC concept which has unlimited variations and which, as a result, may raise issues of law and fact as challenging and numerous as the underlying permanent GIC, for which an individual IGIC would be intended to serve as the bridging mechanism. In other words, if processing the IGIC is functionally equivalent to a GIC in complexity and time required, it would not provide the intended benefit of early, expeditious and predictable implementation while the permanent GIC proposal is resolved. That consideration would appear to argue for a one single IGIC approach, or at most perhaps two, to serve as a "cookie cutter" IGIC for general application in all cases.

At the same time, however, as demonstrated clearly by the events discussed in the preceding section, there has not been (quite properly, in my judgment, as discussed below) majority support for the use of the spot market IGIC as such a cookie cutter. Thus, the instant PPS includes two distinct options, (A) one spot market based as originally proposed for the Transco two year IGIC certificate and rejected twice by a majority of the Commission, and (B) one deficiency based, largely as formulated in the Texas Eastern settlement and adopted by the Commission on a 3-2 vote in that case. The PPS also includes other possibilities highlighted in the questions, such as the "D-3 demand charge" approach. The PPS also discusses the need to consider variations on the main two options, as well as completely different approaches.

Therein lies the fundamental dilemma that, in my view, constitutes the central issue here. How, on one hand, to develop an IGIC concept which will provide for expeditious approval with minimal procedural requirements and, on the other hand, to accommodate differing views (on and off the Commission) as to the substantive approach or approaches which can be proposed. Perhaps, in a somewhat obtuse way, this central issue calls into some question the basic premise of an Interim GIC, by comparison to a permanent GIC. It is conceivable that, under the current situation, Interim GIC proposals under this proposed policy would generally -- or inevitably -- require as much time, process and resources as a permanent proposal, in which case the concept would be of little practical value. In the alternative, it is possible that there really can be a greatly expedited and streamlined process for one or more IGIC concepts.

The AGA letter of April 14, 1989, and the INGAA letter of April 19, 1989, provide separate and different views on the IGIC concept which should be of interest to most commenters. Importantly, in the context of the central issue here, AGA's White Paper on IGICs makes clear that the IGIC proposal must not slow down the Commission's review and action on the numerous pending permanent GIC proposals, lest it be more counter-productive than productive. AGA asserts, among other things, that any IGIC policy must provide broad flexibility in the design of particular IGICs and implementation on a case-by-case basis, while at the same time providing for expeditious adoption if an IGIC is to be useful at all. AGA also addresses a number of other issues, such as applicability, preconditions, method of implementation, Commission approval, duration, sales service nominations, permanent abandonment of sales service, pre-granted abandonment of firm transportation service, refunds, and D-2 nominations. I believe all of those issues are relevant to this PPS and should be of interest to commenters.

INGAA joins AGA in expressing strong opposition to a "cookie cutter" approach for either GICs or IGICs. INGAA also identifies several procedural alternatives for expediting the earlier implementation of permanent GICs, including use of section 4 filings, temporary certificates under section 7 and the PGA mechanism in some form. I would only note that the Commission's (and as a result the industry's) current problem in implementing GICs is in large measure the result of the Commission's lamentable decision in the spring of 1988 to shift from section 4 ratemaking to section 7 certification procedures for the GIC proposals. Given the turmoil created as a result of our loss of the five month suspension procedures under section 4, I am supportive of receiving any comments in this docket, such as those of INGAA, focusing on procedural opportunities to expedite the processing of permanent GICs, as a supplement to, or even an alternative for the IGIC concept. The aforementioned adoption of the so-called "written submission approach" and the "paper hearings" in the El Paso, Transco and Tennessee GIC cases is one example of such possible opportunities. I would hope that these public comments will identify and provide justification for others.

As discussed below, I have very serious reservations about the spot market based IGIC and, if the only alternative today would be the spot market based option, I would oppose the IGIC concept altogether. If the Commission concludes that the benefits of an IGIC concept can only be captured by adopting a single IGIC formulation for general application, then the only practical alternative in the PPS probably is the deficiency based IGIC in some form. My current view, subject to careful review of the forthcoming public comments, is that a deficiency based IGIC formulated to minimize anti-competitive effects could be the most easily adaptable, least obtrusive, and implementable approach. That approach also would have the least negative effect on all other related rates and services during the interim period and would be most susceptible to termination in the event a permanent GIC ultimately is rejected by the Commission or the pipeline (i.e., most "reversible"). Having stated my current views, I look forward with great interest to the forthcoming public comments with regard to the resolution of this fundamental dilemma and central issue.

3. Spot Market Based IGIC

I have serious reservations about a spot market based Interim GIC, and for that reason I support a proposed policy statement with several options for the Interim GIC concept. The spot based approach, now euphemistically called the "competitive price concept," would set pipeline commodity rates at the monthly spot price, plus a small premium. The premium would be intended to support some longer term contracts and pay for future take or pay renegotiations; e.g., buyout and buydown costs. The current WACOG would collapse into an umbrella-type portfolio of spot market gas, plus some longer term contracts, according to the theory.

I am very concerned because the average WACOG nationwide today is about $2.30, with some major pipelines' WACOGs at $2.50 or $2.80, and only one major pipeline with a WACOG even close to average annual spot prices over the last year. A large number of gas contracts, as demonstrated by the average $2.30 WACOG, have prices well above the spot market price, even after extensive take or pay renegotiations and settlements. Consequently, in my view, pipelines would have no option but to virtually collapse all remaining higher priced contracts to spot prices, or even below. I think the conclusion is inevitable -- almost all gas contracts would have to be priced at spot or a netback from spot. Such a conclusion could also be compounded by the pending proposals for NGPA decontrol. The net result would be a very immediate "ramp-down" of higher priced contracts with predictable and devastating impact on the producing community. I also am satisfied that the primary objective and clear intent of the spot market based IGIC is just such an immediate nationwide ramp-down of all contracts with prices above current spot prices, in order to render pipeline sales more competitive with other transportation based supplies.

I also believe that we all have a good deal more to learn about the operation of the evolving, commodity market-type aspects of the natural gas industry. It is not yet predictable, if ever, how the spot market sales will compare to pipeline sales in the event of a "tighter" future winter market. In my judgment, that comparison and the longer term relationship of spot sales and pipeline sales will be a function of a number of marketplace and regulatory variables yet to be determined, such as rate design, overall demand (e.g., electric generation), affiliate regulations, and the speed and effectiveness of GIC implementation, etc. For example, it is not clear that the operation of today's spot market will be the model for the long haul, particularly at a time of more balanced supply and demand or a "tighter" winter market, as was demonstrated during this February's Arctic cold front. Generally, the FERC's regulatory policies should be developed so as to provide maximum flexibility for the evolution and operation of the natural-gas market, while ensuring truly nondiscriminatory open-access transportation, fair competition between pipelines (and their affiliates) and other suppliers, and assured and reliable service for remaining pipeline sales customers. Exactly how gas supplies under long term contract and spot sales will compare or relate over time should be a function of that evolution and operation, rather than be dictated by the Commission in a spot-market based Interim GIC.

Senator Domenici's letter of February 14, 1989, raises a host of questions about the spot market IGIC, in addition to those I have discussed here and those included in the instant order. Rather than paraphrase or repeat those questions here; I have taken the liberty of attaching Senator Dominici's letter to this separate opinion. I commend his questions for review and comment by all interested parties. I would also note that his concerns were reiterated in the letter of March 13, 1989, from Senators McClure, Nickles, Wallop and Bingaman.

For all these reasons, today I would oppose the adoption of the spot market IGIC as the single "cookie cutter" for nationwide implementation as proposed by the Commission staff several times over the past four months. I certainly look forward to public comment on this issue.

4. Long Term Contracts

One of the compromises necessary to reach agreement on issuance of the instant PPS was removal of any suggestion that (A) there is the need for a return to longer term contracting at the wellhead, by comparison to spot market sales, and (B) the Commission has any responsibility any longer to be concerned with the form of gas contracts at the wellhead, as between longer term and spot market. The argument in some quarters is that natural gas is now truly a national commodity freed from all Federal regulatory bondage and the market will determine best the form of contracts, most likely in some type of portfolio of mostly spot market sales, but with some longer term contracts with pipelines for system supply, and with gas utilities and industrial customers. Thus, FERC has no remaining business paying any attention to the form of contracting in the future. The argument from some others is that the optimal economic efficiency approach, as represented by the spot market IGIC, is that there generally should be few, if any, longer term contracts for natural gas at the wellhead in order that the new natural gas commodity market can operate at maximum efficiency, probably as supplemented by gas futures contracts to incorporate the demonstrated advantages of hedging strategies to further rationalize economically the commodity aspect of natural gas. Thus, the second group would argue that FERC policies should virtually mandate that the only acceptable form of contracting is spot market sales.

I have preferred to look at the natural gas industry as an integrated whole from the wellhead to the burner tip, and focus on the historical, as well as future, significance of the exploration, drilling and production sector in ensuring that adequate and reliable supplies are available when needed at the wellhead in the producing fields. To the extent that an expanding economy, increased electric utility use of gas as a boiler fuel, tightened environmental restrictions under various laws and other factors suggest strongly that there will be increased demand for natural gas in the 1990's, I believe that focus must be heightened. Thus, I have considered it responsible and indeed imperative that the Commission attempt wherever possible, consistent with other considerations, to provide at least a favorable regulatory climate, if not outright incentives, for a return to longer term contracts at the wellhead. Indeed, I believe that an essential underlying premise of Order No. 500 was to provide a resolution of the take or pay issues in a manner that would encourage and facilitate long term contracting at the wellhead.

It is clear now that this issue has become a fairly fundamental element of the disagreement over the better approach to an IGIC, as well as permanent GICs. Perhaps, the application of classic economic theory to the natural gas industry as a virtual commodity market can be persuasive. However, I would strenuously object, based on what is known today, to any conclusion that the Commission must attempt to impose a theory of exclusively spot market contracting on the producing sector.

My own view is that it is most likely over time that producers eventually will have the sales portfolio of spot market contracts, long term contracts with pipelines for system supply (supported by GICs), longer term contracts with gas utilities who provide transportation with their Firm Transportation rights equivalent to transmission for sales, and longer term contracts with industrial customers and electric utilities using brokered, reallocated or resold Firm Transportation, as well as interruptible transportation. Under that view, each major purchaser will have a portfolio of supplies, including in various proportions sales gas, spot gas, and longer term contract gas. But, that's just a general notion of how the combination of economic, market, and regulatory factors will play out in the next two years.

The key point in the context of the instant order and the PPS is that the issue of the long term contract versus the spot market sale at the wellhead, and the Commission's role and responsibility for that issue, has been joined as part of the debate on the IGIC. Senator Domenici's letter makes that same point in his questions and concerns, as do several of the questions in the order. Commenters should give careful consideration to that issue in formulating views on the IGIC concept generally and specifically on any particular options or alternatives.

I also continue to believe that it is analytically inescapable that some minimum "critical mass" level of long term contracts for individual producer sales of natural gas is absolutely critical to provide the requisite cash flow and financial certainty to support the increased drilling, E&P, and other related activity in the domestic producing sector necessary to meet projected demand in the future. While some may question the nature and extent of FERC's role in encouraging, assuring, or mandating that result, I simply find no evidence to support the theory that having only short term, 30 day contracts in a classic commodity market approach can ever provide that requisite cash flow or financial certainty. I particularly look forward to public comments that address this apparently inherent

and irreconcilable analytical fatal flaw in the spot market IGIC proposal in this order.

5. State of the GIC Development

Today, pipeline customers apparently do not have full cost accountability, in my judgment, for the pipeline's obligation to serve at the full contract demand level. The customers, it appears, can "swing" on and off the CD sales service without any incurrence of the resulting costs of the service obligation. As a result, it has been asserted that many, if not most, large gas utilities have enjoyed a form of the proverbial "free lunch" by "baseloading" on spot market gas and interruptible transportation and swinging back to pipeline sales only when price or deliverability tighten, as occurred at the beginning of February during the Arctic cold front on a number of pipelines. This practice, generally supported by state regulatory authorities, has led to a more or less pure, least cost purchasing strategy for them. But, it also has serious negative impacts on the pipeline and the dedicated production, which generally stands idle until price or deliverability stringency lead the utility to demand its CD contract volumes, which the pipeline is obligated to provide.

To the extent this asserted practice is in use, I believe the GIC in some form must be implemented to return full cost accountability to such utility purchasing practices. Once given free nominations and adequate service options, the utilities must share the cost responsibility for the dedicated reserves in the future. Coincidentally, once that full responsibility is restored, I believe that longer term wellhead contracts are more likely for both sales for the pipeline's system supply and direct sales using firm transportation.

Pipelines, of course, have claimed that these problems and the resulting exposure to take or pay liabilities and other financial difficulties argue strongly for relief from the obligation to serve requirement. I believe at this time the better course of action is to maintain the obligation to serve unless and until the last captive customer of a pipeline ceases to request sales service and the relevant sales service agreements have expired or been terminated, while pressing ahead ever more vigorously on the GIC/IGIC front. Having said that, however, if the opposition to the GIC/IGIC concept from gas utilities and state regulatory authorities were successful in frustrating the early implementation of an effective form of inventory charge, I would be forced to reconsider my position on the obligation to serve.

Commenters may wish to provide the Commission with their views on these issues in the context of 1989 realities and future projections for the operation of the industry and the natural gas market, as part of their review of the IGIC PPS.

6. Rate Design Policy Statement

The Commission probably will issue the "Policy Statement Providing Guidance with Respect to the Designing of Rates" in the near future. As publicly discussed at the May 17, 1989, meeting, that Policy Statement addresses seasonal rates, the division of fixed costs between demand and commodity charges, capacity adjustments and reductions, discounted transportation, maximum interruptible rates, rates for forward haul and backhaul transportation and exchange arrangements. It is my hope that the Commission will affirmatively entertain rehearing petitions in the PL docket associated with that Policy Statement.

I believe that there are several features of that Policy Statement which are inextricably intertwined from an analytical perspective with a number of the options and issues in the instant order. Of course, it is intuitively obvious that such rate design issues would necessarily have a strong relationship to the form and substance of a particular GIC or IGIC option. Similarly, the procedures applicable to the rate design policy and these proposals for IGIC implementation are necessarily related. Beyond that, the rate design approach to the Modified Fixed Variable method and other specific features may bear directly on the consideration of certain options here, such as the "D-3 demand charge" proposal. Consequently, I would encourage commenters in this docket to provide the Commission with any related views on the Rate Design Policy Statement which would help the Commission to ensure that any decisions here and any decisions under that Policy Statement are fully consistent and harmonious.

7. Texas Eastern Rehearing

As noted in the background discussion, the deficiency based option in this PPS is modeled in part on the permanent GIC approved in the Texas Eastern settlement. The Commission issued its Order Denying Rehearing, Denying Requests for Stay, Granting Clarification and Late Interventions in that docket on April 21, 1989, with a 3-2 vote on the permanent GIC issue. In a separate opinion, dissenting in part, issued with that order, Chairman Hesse stated that she would limit Texas Eastern's authorization of a deficiency based GIC to two years, after which the Commission would have the opportunity to examine whether any

adjustments needed to be made to protect the public interest in a well functioning competitive gas market. That limitation was justified on the basis of (1) potential anti-competitive effects, (2) a potentially manipulated pricing formula, (3) potentially limited rights of customers to obtain alternative supplies, (4) customer support potentially resulting from a lack of meaningful alternatives, and (5) overall competitive objectives of Commission policy.

The vote on the original order was 2-1, with Commissioner Stalon dissenting. At that time last fall, I shared the serious reservations of Commissioner Stalon and various parties in the case about the potential anti-competitive effects of the GIC asserted in the record. On balance, however, I supported the settlement for the reasons set forth in the order, even though it was a "close call" as a matter of judgment.

In sharp contrast, the rehearing order after much debate represents a solid majority, in my view, in support specifically of this negotiated GIC under the Order No. 500 guidelines, as well as the more general proposition that there can and should be a diversity of GIC approaches under Order No. 500, including deficiency-based GIC's where appropriate, tailored to the pipeline, customer, and market specific circumstances in a given case. The history of that debate in this rehearing proceeding lends substantial credence to that conclusion. For example, the rehearing order was deferred for some months pending Commission action in the Transcontinental Gas Pipe Line Corporation (Transco) proceeding (Docket Nos. CP88-391-000 and RP88-167-000, Order Establishing Hearing Procedures issued March 24, 1989) on the theory that the Commission in that case would endorse sua sponte the concept of an immediate and generic spot market-based IGIC. Had the Commission so acted in the Transco proceeding, so the theory went, it then would have granted rehearing in the Texas Eastern docket and conditioned approval of the settlement on removal of the deficiency-based GIC.

That theory having failed utterly to obtain majority support, either for the Transco spot market based IGIC or the outright rejection of the GIC in the settlement, it was next proposed that the Commission grant rehearing in part and limit the duration of this GIC to two years, a de facto IGIC, on the new theory that there were demonstrable anti-competitive effects from the GIC, on the one hand, but on the other hand the Commission should honor for a limited period the settlement negotiated by the parties. Whether such limitation of the GIC to two years would "unravel" the settlement, because of the change in resulting benefits to the pipeline and its customers, respectively, is difficult to predict. That probably was one possible objective of the limitation, with the expectation that a newly negotiated settlement could be subject to a requirement at some point for a spot market-based GIC or IGIC as a condition of approval by the Commission. Again, the second theory failed to obtain majority support and the 2 year proposal was rejected.

The Texas Eastern decision in some respects provides a useful case study of the Commission's current thinking about GICs and IGICs, as I see it. The Commission will carefully consider the potential anti-competitive effects of any proposed GIC, be it deficiency-based or otherwise, and render a judgment based on the relevant facts in the specific situation. Certainly, the Commission recognized that there can, in fact, be GIC's that could be anti-competitive, as well as unduly discriminatory, in practice and, as a result, all GIC proposals will be closely scrutinized. Where, as here, the weight of the available evidence and information and a careful balancing of all relevant factors supports approval of the GIC as negotiated by the parties, the Commission will act accordingly, as set forth in considerable detail in the rehearing order. Where that is not the case, the Commission will take appropriate action to mitigate the anti-competitive effects and undue discrimination, including rejection of the GIC, if necessary.

At the same time, I believe the Commission will not be cajoled, maneuvered or pressed into any unjustified approval of a specific form of spot market-based GIC or IGIC, directly or indirectly, in each and every case, on either a generic or case-specific basis. The Commission's action in the Transco proceeding and the Texas Eastern proceeding demonstrates to my satisfaction that further attempts to achieve that result will not be successful. This conclusion is important in the real world, because it is the essence of the current debate about the instant Proposed IGIC Policy Statement underway since the February 15, 1989, Commission Meeting.

Again, a majority has already rejected the proposal that a Proposed Policy Statement include only a single, inflexible "cookie cutter" form of a spot-market based IGIC, modeled almost exactly on the rejected Transco IGIC. A majority is now, and since early March has been, prepared to issue a Proposed Policy Statement on IGICs, including both deficiency-based and spot market-based IGIC concepts, as well as other possible approaches to reach the objectives for such charges. There appears to be a Commission consensus on the urgent need for some immediate action in this area, judging from the Congressional testimony and public statements of my colleagues. Yet, for reasons not obvious to me, the rhetoric on urgency by all was not matched by action on the scheduling of this long pending, draft Proposed Policy Statement. In short, I am pleased that the Commission has finally issued the Proposed Policy Statement and now will obtain the much needed public comments from all interested parties on this critical issue.

Finally, I should note again the very serious concern I have about the specific spot market-based IGIC originally proposed and rejected in the Transco proceeding and the Texas Eastern rehearing and again recommended for the Proposed Policy Statement on IGICs. I have already provided a detailed exposition of my concerns about that concept. Suffice it to say that I remain convinced that the inevitable consequence of that specific concept, and indeed I believe its fully intended objective, is the almost immediate "ramp down" of higher priced contracts to spot market prices, or a net back below spot market prices, in the face of the current nationwide weighted average cost of gas (WACOG) of about $2.30. I quite simply cannot support either that regulatory objective nor that virtually inevitable result in Transco, Texas Eastern or here.

8. Potential Anti-competitive Effect of IGICs

The issue of the potential anti-competitive effects of GICs has been raised in several cases, such as Texas Eastern, over the past two years. The questions included in the instant order highlight concerns about the anti-competitive issue as it may relate to the IGIC concept generally and more specifically to the identified options. Several observations bear on this issue.

A joint letter of February 10, 1989, from Citizens Energy Corporation, Citizens Gas Supply Corporation, and Hadson Gas Systems, Inc. asserted that implementation of the IGIC concept would have a serious adverse effect on the development of a competitive market at this time, in the absence of countervailing or offsetting action. The corporations called for a "fundamental precondition" of such a charge in the form of firm transportation services which are "fully comparable" to those embodied in the pipeline sales service. They argued that, in the absence of such full comparability of firm transportation, customers would not have a truly competitive alternative and pipelines as a result could use the IGIC and refund mechanism to "undercut" the competition of inferior firm transportation, and even interruptible transportation, by subsidizing the sale of gas with the interim inventory charge. They called on the Commission to establish as a condition precedent for an IGIC that the pipeline simultaneously must institute fully comparable firm transportation by posting transportation tariffs applicable for both firm transportation and the transmission of the pipeline's sales volumes.

The PPS addresses the competitive issues in several important ways responsive at least partially to the concerns identified by Citizens and Hadson. The generally applicable related requirements in the PPS include provisions for standby service, nominations, conversions, storage and receipt points, which should provide customers with clearly available competitive alternatives and substantially comparable firm transportation service simultaneously with the approval of an IGIC proposal, however the interim gas inventory charge itself is calculated and the sales price established. Those particular provisions also would provide a generally uniform and consistent set of reasonably pro-competitive features should the IGIC concept proceed to implementation. Additionally, the provisions reflect several of the same pro-competitive objectives included in the Rate Design Policy Statement. Thus, commenters should focus on this array of provisions and those related aspects of the Rate Design Policy Statement in assessing the relative competitive impact of the IGIC concept as proposed here.

I would note that the Commission in the May 23 orders in Transco (slip op. at p. 4) and Tennessee (slip op. at pp. 7, 17), and the forthcoming Rate Design Policy Statement focus on the full comparability question and expressly address the possibility of pipelines providing transportation service in the form called for by Citizens and Hadson as a "fundamental pre-condition" for an IGIC. To that extent, this particular approach to the potential anti-competitive effects of an IGIC already is under review in those dockets involving permanent GIC's and general rate design.

Of course, there are a variety of possible approaches in terms of (1) the formulation of the IGIC itself, including the aforementioned features; (2) such pre-conditions for approval of an individual IGIC; (3) perhaps a more general parallelism of contemporaneous action by the Commission generically (i) on related rate design issues, and (ii) on the IGIC concept; or (4) some combination of the three. The critical questions for the Commission, just as in the area of permanent GICs, are if, how and to what extent we can proceed with the IGIC concept without creating the serious adverse effect on the competitive situation identified by Citizens and Hadson, among others. In that regard, I believe it would be an error for interested parties to conclude, as some have suggested, that the majority's decision in the Texas Eastern rehearing case stands for the proposition that

the Commission will be insensitive or indifferent to the potential anti-competitive considerations raised by parties in that case and highlighted in Chairman Hesse's partial dissent. The rehearing order addressed that issue, of course, but a very fundamental factor in Texas Eastern for me was that the major customers, in fact, did have competitive alternatives across the spectrum of their pipeline suppliers and the sales, interruptible transportation and firm transportation services provided by them in the respective city gate markets. While those competitive alternatives may not have been as robust in 1988 as they hopefully will become in 1989 and 1990 under the Rate Design Policy Statement and the rapid self-initiated changes underway in the industry today on various pipelines, they nevertheless provided those major utility customers at that time with a clear choice of service and supply alternatives.

While others may obviously disagree with that conclusion, as does Chairman Hesse, I believe any arguable error on the part of the Commission was not a result of insensitivity or indifference to the potential anti-competitive impacts of that particular GIC, in any event. Rather, the disagreement is one of differing judgments as to the case-specific and fact-bound competitive situation at those city gates in 1988 and early 1989. Thus, commentators should pursue the competitive issue vigorously in their analysis of the IGIC concept and the identified options, and provide the Commission with the results. This also is an opportunity to provide the Commission with further views on the general competitive impact of permanent GIC's in the context of our March 23 orders in Transco and Tennessee and the April 27 order in El Paso and the general status of the industry changes now underway.

9. Technical Issues

A. Reconciliation Mechanism

The reconciliation mechanism is described in the PPS (slip op. at p. 19). One area of potential concern in the reconciliation process is the calculation of the pipeline's actual payments for, among other things, take or pay buyout/buydown settlement payments and contract reformation costs. The problem arises from the definition and scope of such so-called "payments" in the context of Order No. 500 and recent decisions of the Commission in direct-billing mechanism cases under that Order. More specifically, the Commission has approved the inclusion of transportation discounts and credits, other non-cash consideration, and various transactions only arguably associated with take or pay buyout/buydown settlement payments and contract reformation costs. (*See* my dissenting opinion in *ANR Pipeline*, 46 FERC ¶ 61,022 (1989)). The Commission also has debated in several cases whether any "payment" related to a so-called "global settlement" of take or pay issues and other, then contemporaneous, but non-take or pay, outstanding issues between a pipeline and a producer-supplier should be eligible as a buyout/buydown payment. (*See*, *Transwestern*, 47 FERC ¶ 61,156 (1989)). The same types of definitions and scope of inclusion under the reconciliation mechanism potentially would lead to grossly inflated revenues retained by the pipeline, where there, in fact, was no actual outlay of funds for a relevant take or pay expenditure. Pending decisions on these issues in the line of Order No. 500 cases also may be relevant to the disposition of the question here. Commenters should focus on the potential negative impact of this definitional problem in terms of the effectiveness of the reconciliation mechanism to guard against excessive charges to pipeline customer's, on one hand, or to ensure that maximum funds are available for distribution to producers for gas purchases and associated premiums, on the other.

I also would recommend parallelling more closely to the PGA mechanism and new PGA regulations by requiring, for example, quarterly filings and an annual reconciliation, as opposed to a two year mechanism. The more frequent and continuing scrutiny during the interim period and the annual reconciliation will provide interested producers, customers, and the Commission with a better opportunity to assess the status of the revenue and expenditure flow and, thereby, may serve as some disincentive for any attempted allocation inconsistent with the spirit of the IGIC objective.

B. Other Features of the IGIC

(1) Term

The term of the certificate should be no more than 2 years or approval of the pending permanent GIC, whichever is earlier.

(2) Nominations

Careful consideration should be given to the form and substance of the so-called "revival" requirement in the event of no permanent GIC to prevent the permanent nature of the IGIC effects,

with some form of equitable approach where the pipeline already has shed excess reserves/deliverability after the nominations are made.

(3) Conversions

As to conversions, consideration also should be given to a "reconversion to sales" feature, but with an equitable approach reflecting the pipeline's likely response to initial conversions of shedding excess reserves/deliverability.

(4) PGA

As to the termination of the PGA and the clearing of the Account No. 191 balance, the PGA should automatically be reinstated if a permanent GIC is not implemented after two years, in the absence of express approval to the contrary by the Commission at that time.

(5) GS Customers

The discussion (slip op. at p. 26) addresses variations of the IGIC concept as a function of a pipeline's gas supply situation. Similarly, it is possible that some separate and/or modified treatment may be appropriate for GS customers (and possibly others) having more limited supply options as a practical matter.

10. Conclusion

This Proposed Policy Statement should provide interested parties with a timely and much needed opportunity to assess the IGIC concept and identified options in the context of today's business and competitive realities in the natural gas industry across the country. The provision for initial public comments and reply comments also will give the Commission the equally much-needed benefit of the industry's current views on the GIC, the IGIC, related rate design matters and other relevant competitive factors in today's increasingly competitive natural gas market. I believe that considerable progress has been made in that competitive direction since the issuance of Order No. 436 in 1985 and Order No. 500 in 1987. This proposed policy statement and the resulting initial comments and reply comments should be another incremental, but meaningful, step in that effort.

For these reasons, I concur.

Charles A. Trabandt
Charles A. Trabandt
Commissioner

ATTACHMENT

PETE V. DOMENICI
NEW MEXICO

United States Senate
WASHINGTON, DC 20510

COMMITTEES:
BUDGET
APPROPRIATIONS
ENERGY AND NATURAL RESOURCES
AGING

February 14, 1989

The Honorable Martha O. Hesse
Chairman
Federal Energy Regulatory Commission
825 North Capital Street, N.E.
Washington, D.C. 20426

Dear Chairman Hesse:

I am writing to express my deep concerns about the negative consequences for both U.S. natural gas producers and long-term natural gas supplies if the Commission adopts the proposed interim Transcontinental Gas Pipe Line Corporation gas inventory charge ("GIC"). I understand that the Commission will consider the Transcontinental GIC at its Wednesday, February 15 meeting.

As a general principle, I believe that a properly designed GIC can simultaneously benefit producers, pipelines, local distribution companies and consumers by helping to match gas supply with demand. However, the proposed Transcontinental GIC would appear to be not in keeping with the principles established by FERC Order No. 500, and potentially in conflict with Federal law.

Before the proposed Transcontinental GIC is adopted, there are numerous technical, policy and legal questions that must be fully considered and understood by the Commission.

First, what impact would the proposed GIC have on domestic exploration and long-term natural gas supplies? Would it artificially drive down the wellhead price of natural gas, thereby reducing the incentive for producers to explore for new reserves of natural gas? Would producers, particularly independents, be willing to enter into long-term gas supply contracts at spot market prices? What are the implications for gas supply if the revenues for the purchase of gas at the wellhead may be diverted from producers to the pipeline? What are the implications for gas supply when the purchase price is indexed to a "spot market" price? And what evidence is there that the proposed price index would, in fact, accurately reflect Transcontinental's gas purchases? What assurance does the Commission have that the proposed use of the "spot market" price by Transcontinental to determine its GIC cannot be manipulated by the pipeline itself, as it is a major player in the region?

Second, what impact would the proposed GIC have on natural gas producers, particularly independents? Would it encourage the pipeline to abrogate ("market out") existing supply contracts with producers? How would that affect independent producers' financial viability?

Third, is the proposed GIC in keeping with Federal law and existing Commission regulations? Would the proposed GIC allow Transcontinental to recover more than the cost of purchased gas in the gas cost component of its jurisdictional sales rate? Would that be lawful? If Transcontinental is allowed to recover a margin, or profit, in the purchased gas component of its rates, rather than being held to a dollar-for-dollar passthrough of purchased gas costs, would it be allowed to retain this profit? Why shouldn't the pipeline be required to pass that on to its customers? If Transcontinental is allowed to add a "profit" for itself in the purchased gas component of its rates, is the Commission, in effect, avoiding its duty under the Natural Gas Act to see that all rates for sales in interstate commerce for resale are "just and reasonable." If not, how will the Commission insure that all such rates and charges are "just and reasonable" as is required by Federal law and Commission precedent? If the Commission does not intend to exercise its jurisdiction under the Natural Gas Act to insure that Transcontinental's rates and charges are "just and reasonable", what is the effect, if any, of Title I of the NGPA on sales in interstate commerce for resale by the pipeline with a GIC? For example, could Transcontinental itself produce at the wellhead low-priced "old gas" and resell it at a price that exceeds the maximum lawful price? Similarly, could it purchase low-priced "old gas" from a producer and resell it at a price that exceeds the maximum lawful price? If the pipeline were allowed to do this, would producers supplying the pipeline also be excused from maximum lawful prices -- or just the pipeline? If Transcontinental is allowed to make a profit by marking up the price of purchased gas, would it still be permitted to recover a full return from its customers? In other words, would the GIC give the pipeline two profit centers -- the return on equity, or profit, as well as a new profit center in the purchased gas component of the rates? Will the GIC include only gas inventory costs, or can other costs be included? When a pipeline with a GIC is allowed to make some form of annual or monthly charge, in addition to the commodity charge for the gas when sold, must this annual or monthly charge be flowed through to the producers to compensate them for holding gas in the ground pending request for service, or is this annual or monthly charge also a new potential profit center for the pipeline? Is it in fact possible for the Commission to make the requisite finding that the markets for gas are workably competitive when new competitors of the pipeline are offered only interruptible service, and then at rates equal to, or greater than, the firm rates? In summary, is the Commission fully convinced that the proposed Transcontinental GIC would be legally sustainable? Would it violate the spirit or the letter of the Natural Gas Act, the Natural Gas Policy Act of 1978, or FERC Order No. 436/500?

At a time when the United States is experiencing declining domestic production and increasing foreign energy dependency, any Commission action which tends to reduce domestic exploration and production would, in my opinion, be ill-advised. Until the issues and questions outlined above, as well as numerous other significant technical, legal and policy questions are fully explored and their implications are completely understood, Commission action on the Transcontinental GIC would clearly be premature.

And finally, because the Transcontinental GIC involves fundamental matters of energy policy, I would strongly urge the Commission to withhold action until such time as Department of Energy Secretary-designate Watkins has had an opportunity to review the matter and to provide to the Commission the Department's judgment on this matter.

Please make this letter a part of the public record in the appropriate dockets.

Sincerely,

Pete V. Domenici

Pete V. Domenici
United States Senator

PVD:HU

cc: Commissioner Trabandt
Commissioner Stalon
Commissioner Moler
Commissioner Langdon

Senator **Bingaman**. Thank you very much.

Next we will hear from Commissioner Elizabeth Anne Moler. We are very pleased to have you here.

STATEMENT OF ELIZABETH ANNE MOLER, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Ms. **Moler**. Thank you, Mr. Chairman.

This is my first return visit to the committee since leaving here not quite a year ago. I have sat at this table many times, but I will admit it has never felt quite like this before.

I appreciate the opportunity to appear before the subcommittee to present my views concerning the Commission's implementation of gas inventory charges. I believe that it is essential for the Commission to complete its unfinished task of implementing GICs. We must do so in order to provide a means for pipelines to recover the costs of maintaining long-term gas supplies for their customers and their demand charge.

The Commission's approach has been to implement GICs on a case-by-case basis. We have encouraged the use of settlement procedures, but we have not yet succeeded in implementing a GIC program on most pipelines. The two permanent GICs we have approved have been in response to proposals by the pipelines; and, indeed, in one case, the Texas Eastern case, it was a settlement proposal that had the vigorous support of the producers, the pipeline, industrial customers and LDCs on that pipeline.

We have 10 applications pending before the Commission for GICs; nine are for a permanent GIC, and one is for an interim.

We are considering implementing GICs on an interim basis and have issued the proposed policy statement outlining the two types of interim GICs as possibilities, as you have observed: the competitive price or spot price concept and the deficiency charge basis.

The industry is split on the efficacy of each approach. Not surprisingly, that split is, at times, mirrored on the Commission.

I, frankly, am not wedded to either concept as being the only approach to be taken. What works on Texas Eastern and Transwestern, for example, may or may not work on other pipeline systems. Pipelines are different, their gas supply contracts are different, their customers are different, and the competitive circumstances are different.

In the current regulatory environment, there is an unprecedented degree of competition among and between pipelines, producer-marketers and independent marketers. Local distribution companies and industrial customers have an increasingly competitive array of supply and service options available to them.

No one I know believes that the increasingly competitive world is a perfect, fully competitive environment, but it is different than anything we have encountered before. The challenge before us is to provide a regulatory regime that will work in the real world and respond to that changing environment.

I intend to do my best to respond to the challenge and I hope that the Commission will have your support.

My written testimony responds to the specific questions that were enumerated in your letter asking us to testify. I will, of course, be pleased to answer any questions.

Thank you.

[The prepared statement of Ms. Moler follows:]

Testimony of Elizabeth Anne Moler
Member of the Federal Energy Regulatory Commission
Before The
Subcommittee on Mineral Resources Development and Production
Committee on Energy and Natural Resources
United States Senate
September 14, 1989

Testimony of Elizabeth Anne Moler
Member of the Federal Energy Regulatory Commission
Before The
Subcommittee on Mineral Resources Development and Production
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September 14, 1989

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee to present my views concerning the Commission's implementation of gas inventory charge proposals or "GIC's".

I believe that it is essential for the Commission to complete its unfinished task of implementing GIC's. As far as I am concerned, there is no more crucial task facing the Commission and the gas industry today. We must do so in order to provide a means for pipelines to recover the costs of maintaining long-term gas supplies for their customers.

As the Subcommittee members are aware, the Commission's take or pay passthrough mechanism expired March 30, 1989. That mechanism was provided to encourage pipelines and producers to renegotiate outmoded natural gas supply contracts, and to allow for a portion of the costs of reforming those contracts to be passed through to the pipeline's customers.

In Order No. 500, the Commission adopted a policy (codified in §2.105 of the Commission's regulations) governing the passthrough of charges for maintaining supplies for their customers. Our regulations prohibit the passthrough of take or pay charges except by means of a GIC.

The Commission's approach has been to deal with individual pipeline proposals to implement GIC's on a case-by-case basis. We have encouraged the use of settlement procedures to fashion permanent GIC's on a case-by-case basis. But we have not yet succeeded in implementing a GIC program on most pipelines. Indeed, only two permanent GIC's have been approved; ten additional applications are pending (nine for a permanent GIC; one for an interim). Thus, we currently have no effective mechanism for guarding against the buildup of future take or pay charges in place on most pipeline systems.

Factual circumstances vary from pipeline to pipeline. Pipelines have different sales and transportation markets, customer demand profiles and gas supply contracts with varying terms and conditions which need to be considered. Any case-by-case approach is a slow, deliberative one. But we are committed to completing the task.

Faced with the reality of a slow process, the Commission issued a notice on May 30 that it is considering an interim GIC mechanism. Our Notice of Proposed Policy Statement explained the

Commission's rationale for looking at an interim mechanism. It would serve as a --

> bridge between the expiration of one phase of addressing the take or pay problem -- the equitable sharing direct billing problem -- and the beginning of the next phase of dealing with future accumulations of take or pay -- the implementation of gas inventory charges -- throughout the gas pipeline industry.

The Commission is evaluating the comments we received on the interim proposed policy statement. We are faced with the question of whether we should try to fashion an interim solution to a long-term problem. The task is inherently difficult, but I believe an interim GIC is worth exploring nonetheless because of the necessarily slow pace of the case-by-case approach to permanent GIC's.

The proposed policy statement posed two types of interim GIC's as possibilities: the "competitive price" concept and the "deficiency charge" method. Each concept has vigorous supporters. The industry is split on the efficacy of each approach; not surprisingly, that split is, at times, mirrored on the Commission.

I, frankly, am not wedded to either concept as being the only approach to be taken. What works on Texas Eastern and Transwestern, for example, may or may not work on other pipeline systems. The pipelines are different; their gas supply contracts are different; the customers are different; the competitive circumstances are different. The permanent GIC authorized will, no doubt, be different, too, from system to system.

In the real world, most producers now sell their natural gas on a spot price basis. Spot price transactions are simply that -- an agreement to sell natural gas for a short period of time at an agreed upon spot price. Those who are willing to sell natural gas for a longer period of time expect to command a premium above the spot price for their willingness to commit supplies. The price and non-price terms of a longer term contract differ from short-term contracts.

In the current regulatory environment, there is an unprecedented degree of competition among and between pipelines, producer-marketers, and independent marketers. Local distribution company customers, and industrial customers, have an increasingly competitive array of supply and service options available to them, and purchasing decisions to make. No one I know believes that the increasingly competitive world is a perfect, fully competitive environment; but it is different than anything we have encountered before. The challenge before us is to provide a regulatory regime that will work in the real world, and respond to that changing environment.

The Subcommittee requested that our testimony be directed to specific enumerated issues. Let me respond to each.

Relationship Between GIC's and Other Regulatory Policies

The Commission's natural gas regulatory policies are increasingly directed toward assuring a long-term competitive environment. Our recent rate design policy statement recognizes that the environment has changed fundamentally since the modified fixed variable rate design was first adopted, and seeks to enable those we regulate to adapt to that changing world.

The recovery of take or pay buyout and buydown costs under the special Order No. 500 program has expired. The only means available for a pipeline to pass through take or pay costs associated with providing long-term natural gas supplies is through a gas inventory charge mechanism.

I am committed to finalizing a permanent rule on open access transportation; I believe we will come to agreement on a final rule well before the end of the year.

Interim vs. Permanent GIC's

I was a strong supporter of seeking comments on interim GIC's. I personally have learned a great deal from the process. I also believe that seeking comments has forced the industry to take stock of the array of pending proposals, for both interim and permanent GIC's. I still support approving an interim mechanism to enable those who wish to do so to take advantage of it pending action on a permanent, fully litigated GIC.

Rationale For "Competitive Price" and "Deficiency Charge" Options

The Commission's rationale for considering both pricing options was set forth in our Notice of Proposed Policy Statement.

Impact of Competitive Price Option

I am certainly aware of some independent producers' concerns that implementation of the competitive price option will lower the market price for natural gas and have a negative long-term effect on natural gas supplies.

I am willing to explore the competitive price option because of the reality of the natural gas marketplace today. As outlined above, natural gas supplies are routinely bought and sold on a competitive, or spot price, basis. Long-term sales contracts are not now the norm. When they are entered into, producers sell at spot, plus a premium tailored to the particular contract. I, for one, do not believe it is necessary for the Commission to insist that a pipeline give up its PGA mechanism, whereby it passes through its portfolio of natural gas supply costs, in order to have a GIC approved. I believe it is appropriate for the Commission to allow the pipeline to impose a surcharge insuring availability of long-term natural gas supplies. Certainly any producer, or other marketer contracting directly with a LDC or end user, is able to enter into a gas sales agreement that includes such a charge; pipelines ought to be able to do so, too.

The Commission recently approved a seasonal sales program proposal submitted by Panhandle Eastern Pipe Line Company. 1/ The program was a controversial one. Independent producers expressed the fear there that it would be used by the pipeline to abrogate sales contracts. The Commission responded to the producers' pleadings by indicating:

> [T]he Commission makes clear that its approval of Panhandle's proposal should not alter or otherwise modify Panhandle's commitments under its current supply contracts. As stated above, the Commission's actions here are not intended to serve as the basis to affect any of Panhandle's current contract obligations with its producer suppliers.

1/ 47 FERC ¶61,472.

We should reiterate that commitment upon implementation of any type of spot price, or competitive price, GIC.

Implementation of GIC's as the Result of Settlements

The Commission's notice of proposed policy statement on interim GIC's includes an express recognition that "the Commission continues to support strongly the use of settlement procedures, where appropriate, to fashion permanent GIC's on a case by case basis." If and when we adopt an interim GIC rule, I would not expect to do "tailor made" interim GIC's.

I will be pleased to respond to any questions the Subcommittee may have.

Senator BINGAMAN. Thank you very much.

Our final witness is Commissioner Jerry Langdon. We are very pleased to have you here and we look forward to your testimony.

STATEMENT OF JERRY J. LANGDON, COMMISSIONER, FEDERAL ENERGY REGULATORY COMMISSION

Mr. LANGDON. Good morning. Thank you, Mr. Chairman. I appreciate very much having the opportunity to appear here this morning to discuss what I think is a very important subject relating to gas inventory charges and the transitional role that they play in moving towards a more competitive natural gas market.

I also have prepared a more detailed statement, which I have submitted to the subcommittee for the record, but, in the interest of time, I would like to make mention only of my general views on the significance of gas inventory charges.

The extensive efforts of the pipelines and producers to resolve past take-or-pay problems under the equitable sharing mechanism of order number 500 have resulted in significant amounts of pipeline gas being released from traditional, long-term take-or-pay contracts. But this process has not, in every case, addressed the problem of how producers, pipelines and consumers will plan gas purchase strategies for the future.

How will they determine how much of a commitment to make to the month-to-month spot market of natural gas versus long-term gas contracting, for example?

Producers must be assured that there are markets for appropriately priced reserves of natural gas in order to make necessary financial commitments to future exploration efforts; while pipeline companies must have confidence in gas volumes that their customers intend to purchase and in their ability to recover the cost of maintaining these supplies in inventory.

Lastly, consumers must be able to depend on a stable and secure supply of natural gas to meet all or part of their peak needs.

I think a properly designed GIC can accomplish these objectives and create a relationship between the price of gas at the wellhead and at the city gate. For these reasons I strongly support the GIC concept.

I am also confident that the Commission need not mandate a generic GIC structure. The differences between pipelines, in their efforts to compete with one another, other markets, and other producers, will undoubtedly produce a number of innovative, market-sensitive sales and purchase strategies. The freedom of choice accorded to customers through open access should allow LDCs and industrial customers to make rational purchasing decisions based upon such factors as price and reliability.

The goal of the Commission in evaluating each of these proposals has, and I think will continue to be, one of protecting the public interest and assuring adequate supplies of natural gas at reasonable prices.

I also thank you for the opportunity to appear here today and look forward to your questions.

[The prepared statement of Mr. Langdon follows:]

Senate Committee on Energy and Natural Resources
Subcommittee on Mineral Resources Development and Production

Oversight Hearings
on
Gas Inventory Charges
September 14, 1989

Opening Statement of Commissioner Jerry J. Langdon
Federal Energy Regulatory Commission

Good morning Mr. Chairman and members of the Committee. I would like to thank you for the invitation to appear before the Subcommittee and for your interests in the importance of gas inventory charges (GICs) to the transition to more competitive natural gas markets.

The extensive efforts of pipelines and producers to resolve past take-or-pay problems under the equitable sharing mechanism of Order No. 500 have resulted in significant amounts of pipeline gas being released from traditional long-term take-or-pay contracts. But this process has not, in every case, addressed the problem of how producers, pipelines and consumers will plan gas purchase strategies for the future: how they will determine how much of a commitment to make to the month-to-month spot market for natural gas versus longer termed gas contracting. Producers must be assured that there are markets for appropriately price reserves of natural gas in order to make necessary financial commitments to future exploration efforts. Pipeline companies must have confidence in the gas volumes that their customers intend to purchase and in their ability to recover the cost of maintaining these supplies in inventory. Lastly, consumers must be able to depend on a stable and secure supply of natural gas to meet all or part of their peak needs.

GICs are intended to accomplish these objectives and to create a relationship between the price of gas at the wellhead and at the city-gate. For these reasons, I strongly support the GIC concept.

Both Transwestern and Texas Eastern have now accepted GICs. Transwestern's GIC is based on a posted price concept, whereas Texas Eastern's is a "deficiency" charge which will be billed if a customer fails to meet a percentage of its purchase commitment. I supported the rehearing order on Texas Eastern's GIC and the orders approving the tariff changes implementing the GICs on both of these systems beginning this winter because I believe it is important to see how these two very differently structured GICs operate in practice, and on two very different pipeline systems.

I also supported the Commission's initiation of "paper hearing" procedures on proposals by El Paso, Tennessee and Transco to implement permanent GICs. These procedures are necessary to determine whether a particular pipeline has enough market competition for the Commission to approve a market-based GIC. They are also necessary to determine whether pipeline customers have access to gas supplies that are equally as reliable as pipeline system supply, so that they have a meaningful choice when they make their nominations. At the same time, conducting a "paper hearing" can reduce the amount of time it takes to put a permanent GIC into place.

Since timing is important in preventing the accumulation of take-or-pay liability, I supported the issuance of a Notice of Proposed Policy Statement on interim GICs. The importance of interim GICs is likely to depend on the results of the paper hearings on permanent proposals. If a permanent GIC can be issued on an expedited basis, there may not be a need for separate interim measures. However, because various questions had been raised about the structure and operation of GICs in general and interim GICs in particular, I advocated providing an opportunity for public comment on this subject.

Although I support GICs, I dissented from a proposal by Panhandle Eastern Pipe Line Company to implement a "seasonal sales program." Under this program, which a majority of the Commissioners approved in June and which is pending rehearing before the Commission, Panhandle is authorized through March 31, 1991 to base its monthly gas sales price on a regional spot price composite for the preceding month, plus an add-on which is roughly equal to a transportation differential between the wellhead and the city gate. Since Panhandle won't be using its PGA during the 21-month period that the program is in effect, its gas costs won't reflect the accumulated balance in Panhandle's deferred account (currently about $48.9 million), and Panhandle hopes to use increased sales under the program to help reduce its deferred account. In return, Panhandle's customers make a "best efforts" commitment to purchase specified volumes of gas from Panhandle for the duration of the program. If they fail to meet 90 percent of this commitment for two consecutive months, Panhandle can terminate the program and reinstitute its PGA.

I had several reasons for dissenting in the Panhandle case. Fundamentally, I was concerned that Panhandle's seasonal program was analogous to a GIC without the safeguards of the paper hearing procedures. If Panhandle's customers fail to meet 90 percent of their "best efforts" commitments, Panhandle can terminate the program and recover its large deferred account balance. In this sense, the prospect of being billed a portion of Panhandle's unrecovered purchased gas costs functions like a GIC because it induces customers to purchase gas from Panhandle or pay an additional charge if they do not. Yet it lacks the safeguards of comparable access that would be required prior to implementation of a GIC, to ensure that customers' purchasing decisions are based on meaningful service alternatives.

The use of spot prices to determine Panhandle's monthly commodity cost of purchased gas also poses a number of problems. Since Panhandle posts its price for a particular month on the day before the beginning of the month in which the price will be in effect, the referenced average is based on the spot market prices delivered into midcontinent pipelines in the prior month, and the advance posting requirement can therefore give Panhandle a competitive advantage during periods when prices are trending upward. The reliability of the spot index is related both to competition at the wellhead and the fact that spot prices aren't weight-averaged. The general propriety of using spot market prices to establish a gas pricing formula is an issue in the GIC paper hearing proceedings, and I questioned its use in Panhandle, where there wasn't any record evidence to support its reliability as a pricing index.

Finally, I was concerned that the program may give Panhandle another unfair competitive advantage over other sellers of gas. While the price of Panhandle's gas under this program is higher than the price customers would pay for spot market gas transported at interruptible rates, this comparison ignores the likelihood of discounts to compensate for the lower reliability of spot purchases. By contrast, each of the Commission's paper hearing orders has emphasized the need for evidence on comparable access to equally reliable supplies, prior to authorization of a market-based GIC.

I am confident that the Commission need not mandate a generic GIC structure. The differences between pipelines and their efforts to compete with one another, marketers and producers will undoubtedly produce a number of innovative, market sensitive, marketing strategies. The freedom of choice accorded consumers through open access will allow LDC's and industrial consumers to make rational purchasing decisions based upon such factors as price and reliability. The goal of the Commission in evaluating each of these proposals has, and will continue to be, one of protecting the public interest and in assuring adequate supplies of natural gas at reasonable prices. Thank you.

Senator BINGAMAN. Thank you very much.

Let me start out and ask a few questions. Chairman Hesse, let me ask you first, what is the current status of the proposed policy statement on interim GICs? When do you estimate that the Commission will decide whether or not to issue a final policy statement on interim GICs?

Ms. HESSE. Mr. Chairman, we have received comments from the industry and interested parties and have prepared a summary of those. We have not yet made a proposal to the Commission—or I should say I have not yet made a proposal to the Commission about what I think should be in a final interim policy statement.

It is my intention and my hope that we will do that sometime in the next month or so. That will then be an interim policy statement on GICs, and that will have to be subject to rehearing, in case someone points out flaws or inappropriate issues in the policy statement. And then it is up to the individual pipelines to determine whether or not they wish to have an interim gas inventory charge and what kind of an interim gas inventory charge they want.

They would then have to prepare a proposal and submit it to the Commission and we would have to go through the whole approval process.

We are looking at, actually, a very long time, in my view, before we have the first interim gas inventory charge in place, regardless of composition.

Senator BINGAMAN. But your expectation would be that sometime in the next month or so, there would be a proposal made for a final policy statement on interim GICs, as I understand your response?

Ms. HESSE. I would think and would hope that, perhaps, if not late in October, that certainly in early November—at probably the first meeting in November, that we would put on the agenda a discussion of the interim policy statement.

Senator BINGAMAN. Thank you.

Commissioner Langdon, I guess there have been some reports in the trade press, and recent comments that you made before the Natural Gas Roundtable, indicating some doubts about the wisdom of the whole idea of interim GICs. Would you elaborate on that? Am I properly characterizing those reports or your comments?

Mr. LANGDON. I would be glad to elaborate on it, at the risk of sounding like I have prejudged interim GICs.

I supported the interim proposed policy statement in an effort to try to get comments from the public, with respect to how an interim GIC could be implemented and how it could bridge the gap between our current situation and our future situation.

My concern is, and as I think I said at the roundtable, that there is something to me very inconsistent about trying to make a long-term plan that is based on a 1-year or 2-year interim effort, particularly in regard to the efforts that have been as significant to each link of the marketing chain as gas inventory charges ultimately will be.

As Chairman Hesse just mentioned, we have just gotten the comments back; and I look forward to reviewing those in greater detail than I have. I think, from strictly a philosophical point of view, the short nature of an interim gas inventory charge, versus total long-term restructuring efforts, seems inconsistent to me.

Ms. HESSE. Mr. Chairman, may I add something?

Senator BINGAMAN. Yes, you certainly may.

Ms. HESSE. What each of us wants is a permanent gas inventory charge implemented, in place and operating for the pipelines if they should choose to have one.

What we hoped to do with the idea of an interim gas inventory charge was to come up with a set of principles that could provide some instant short-term relief for the pipelines and the producers so that they in turn would get paid for producing.

While the permanent gas inventory charge was in hearing, it was intended, in my view, to be a stopgap measure to provide some short-term relief. What it has become, I regret to say, is sort of a full-blown controversy over what we really meant. It was just short-term relief while we worked on permanent gas inventory charges.

I think that Commissioner Langdon and Commissioner Stalon agree with me that that was the purpose, and if we can find a way not to have an interim gas inventory charge, to in fact go directly to a permanent gas inventory charge, that would be our preference.

Senator BINGAMAN. Let me just clarify this in my own mind. I think in response to my earlier question you had said that you thought it would be a very long time before an interim gas inventory charge was approved by the Commission.

Ms. HESSE. I do.

Senator BINGAMAN. If in fact the purpose of the gas inventory charge is to give direction during this shorter period, it seems that it cannot serve that purpose if in fact we are not going to have it used in the near future.

Ms. HESSE. The thing that I want to point out is that it is an interim policy. We are at the same time processing permanent gas inventory charges. We have approved two permanent gas inventory charges. We are looking at and processing through paper hearings a number of permanent gas inventory charge proposals.

The permanent gas inventory charge proposal, which was a policy statement and was part of Order 500, is moving along. We are still working on that, and unless we can come to some reasonably quick decision, my view is that we will go ahead and continue processing permanent gas inventory charge proposals, and that the proposals may in fact not be necessary.

I think that is essentially what Commissioner Langdon has said as well. It is very confusing.

Senator BINGAMAN. I would agree with that.

Let me just be clear in my own mind. You are saying that while proceeding with the preparation of this interim policy which would be proposed and discussed by the Commission in November or be on the agenda at that time, you really think the better course is to proceed with the permanent gas inventory charge?

Ms. HESSE. We are. We have been. We will proceed with permanent gas inventory charges because that is, after all, the ultimate goal.

Senator BINGAMAN. What is the purpose of having it on a dual track, parallel tracks? Why not either do the permanent or do the interim and then the permanent but not do the permanent and also do the interim?

Ms. **Hesse**. I guess we will not do interims, then. [Laughter.]

The purpose of an interim was only to provide, as I said before, some short-term instant relief while we processed a permanent gas inventory charge proposal.

Senator **Bingaman**. It is not, however, serving that purpose?

Ms. **Hesse**. It is not. It is becoming an example of no good deed goes unpunished.

Senator **Bingaman**. So your preference is just not to proceed further on the idea of an interim charge and go directly, as you have been, to approval of permanent charges?

Ms. **Hesse**. My goal has always been permanent gas inventory charges. If we can come up with a short-term interim solution quickly and efficiently while we do permanent gas inventory charges, then I would like to have an interim. If we cannot, then no.

Senator **Bingaman**. Your present expectation is that you cannot, as I understand your answer to the question?

Ms. **Hesse**. I am the ultimate optimist, and so I am not yet willing to absolutely say we cannot do interim gas inventory charges. I am still hopeful we can.

As you know, we have been working on the concept of an interim gas inventory charge for quite some time. In the meantime, we are working on the permanent ones as well.

Senator **Bingaman**. You are the ultimate optimist, but you do think it will be a very long time before you approve an interim gas inventory charge?

Ms. **Hesse**. Yes, unless we can come to terms very quickly.

Senator **Bingaman**. All right. Let me shift the question just a little here. This relates to some of the issues that Senators Domenici, Nickles and others were raising in the August 15 letter. This, again, is to Chairman Hesse.

In the August 15 response to the letter that Senator Nickles and I sent out on July 11, let me quote two items which you stated.

You said, first, "The Commission proposal does not limit the price a pipeline pays a gas supplier." Secondly, "The Commission does not intend to affect either the pipeline's cost of gas or its contractual relationship with producers." I think those are exact quotes.

It would appear, however, that if a pipeline's volumetric commodity charge is limited to the spot market price of gas and the pipeline's GIC is limited to a percent of the spot market price, are you not on average limiting the price that a pipeline may pay a producer at the wellhead?

Ms. **Hesse**. No, I think not.

First of all, a gas inventory charge has to do with the arrangement between the pipeline and the customer, not the arrangement between the producer and the pipeline. That is a separate arrangement.

The gas inventory charge, at least a competitively based gas inventory charge, is based on two things. One is the commodity charge for the gas, which would be charged at a competitive market price; and then on top of that is a premium. It is the premium that the pipeline wishes to pay to hold long-term gas supply with producers.

It is not at all saying that if a gas inventory charge has as one of the two components a spot market or competitively priced commodity charge that that is the only money that the producer is going to get. That is simply not the case. The producer will get whatever he negotiates with the pipeline, first of all; but the gas inventory charge involves not only a spot market price but a premium price on top of that.

Senator BINGAMAN. Let me see if you would agree with this. The only way that a pipeline could afford to pay a producer a price that exceeded the spot market price plus the GIC would be to pay another producer a price that is less than the spot market price plus the GIC.

Ms. HESSE. I do not think that that necessarily follows. In the first place, the contract that a pipeline has with individual producers is not reflected one by one in the GIC. It is based on an umbrella of all contracts. It has nothing to do with the negotiations that a pipeline has with a specific producer or the contracts that exist.

Would you add something to that?

Mr. STALON. I would add a point. The question can be interpreted as one of very narrow logic. In very narrow logic, the answer is yes.

If you are buying and the pipeline is limited in the average it will pay—some will be paid higher and some will be paid less—logic dictates the answer yes.

I think the more correct answer, however, and the more relevant answer for the market is that I would expect the pipeline to put together a portfolio of gas, and in that portfolio of gas it would have some long-term supplies in which it would pay the producer a price plus a premium and others it would buy spot price.

I would expect any sensible competitive merchant in this business to have in his portfolio some spot price. The more spot price it has, the more he could pay the other producers higher than spot price out of the premium.

I would emphasize the point here that I think is being overlooked in some of this discussion. The pipeline company merchant is increasingly competitive. The FERC has been removing its monopoly power. It is my intent to remove all of it. One should not expect to exercise monopoly power after it has been destroyed.

If the pipeline company is deprived of its monopoly power, it will either be given the flexibility to buy gas as it sees fit in a competitive market or it will disappear as a merchant.

We cannot impose on pipelines any obligation to pay prices over those paid by other noncompeting merchants and expect the pipeline company to survive as a merchant. So my view in this process is that I am not trying to create an arrangement that the pipeline company can use to influence the market price of gas. I am trying to create an arrangement where no single party has control over the price of gas, but where the competitive market will determine the price of gas.

If the pipeline as a merchant cannot compete, he will be eliminated. If large producers do not like the GICs, let them produce their own. Let them compete by creating a higher or lower one, because if the pipeline does not create one for survival, another merchant will.

My attempt is to allow the pipeline company to survive as a merchant if he can survive as a merchant. I am skeptical that he can survive as a merchant under the scheme of regulation. If he can survive, however, and the parties want him to survive, I want to let him survive. That requires giving him some discretion. I want to let him survive in a game where competition is preserved.

Senator BINGAMAN. Do any of the other Commissioners wish to comment on this issue to any extent which we have not already?

Yes, Commissioner Trabandt.

Mr. TRABANDT. I think that whether it is characterized as broad or narrow, the essence of your question and, really, the essence of the debate that has occurred since February is whether or not the particular form of spot market interim GIC that was proposed in the policy statement would effectively provide for wellhead contract prices at any material level above spot market.

As defined in the policy statement and as originally developed in February, I think the answer to that is probably no. If we use that particular formulation, the combination of take-or-pay costs that would have to be incorporated, the combination of prepayment costs, interest on prepayments, the use of the premium for purposes of further take-or-pay renegotiation which has to occur in contract reformation and contract termination which has to occur, the bulk of the funds that would be accrued in the premium would not go to producers at the wellhead for current gas purchases. The bulk of those funds would have to be used to prevent incurring take or pay for which the GIC was originally designed.

Recall that under Order 500 the basic scheme was that we would allow direct billing and all of the other mechanisms associated with it for the take-or-pay buyout and buydown costs, but only to a time certain, originally last December and then eventually this past March. After that, all take or pay costs that were incurred by pipelines were going to have to be handled by these gas inventory charges. That was the theory of the proposal that we adopted two years ago.

Because of the delay in our implementation of gas inventory charges, we now face the situation where pipelines currently do not have an approved mechanism other than to put them in commodity charges for recapturing those take-or-pay funds or take-or-pay payments.

The theory of this particular proposal, and the reason it has caused so much understandable concern, is that the total amount of revenue that would be collected by the pipeline would simply be insufficient to handle the take-or-pay costs that the pipeline has to deal with and also to maintain wellhead prices at any material level above spot market. In a nutshell, that is basically what it comes down to.

I know the Chairman may disagree, but as I indicated it is not surprising that that is the way it came out, because in February that was exactly what was intended; i.e., to bring the prices down for the two reasons I stated in my summary: One, so pipelines would be competitive with the spot market merchants; and two, so that the pipelines would not incur further take or pay, because if the wellhead contracts were brought down in the general range of spot, then take or pay would be a historical artifact. That is the situation we had then.

The reason why an interim GIC may have certain value on some pipelines is because, in the absence of a GIC, those pipelines are facing today some build-up of take or pay exposure. Even though the proposal that we adopted has been successful in resolving a lot of it, that has still not stopped the possibility for further accrual.

So pipelines are faced with a situation where they may have to have one of two untenable results: One, they either accrue the further take-or-pay build-up because there is nothing there to fund it or nothing there to deal with it; or more possibly, and I think think this is the real problem that has occurred in the market, two, they shed reserves and they lose the capability to meet peak demand.

While we continue through the process, sometimes a very lengthy process, of trying to put in place these permanent GICs, that remains a problem. That is the rationale at least for some pipeline systems to support an interim GIC.

So the question becomes if you are going to have an interim, how would you propose to price it. So that is the dilemma that we have. You have heard all kinds of arguments for various options.

The key thing I think that the committee focused on, and Senators Domenici and Nickles, is that, if we were to lock in most of the pipeline systems on an interim GIC, as it was originally proposed with the spot market pricing with WACOG at $2.30 nationally, I do not see how you can come to any other conclusion except that wellhead prices have to come down and very fast.

Senator Bingaman. Commissioner Stalon.

Mr. Stalon. I would like to respond because I realize every glass can be described as half full or half empty, but I would not accept the characterization of our February initiatives as driving down the price of gas to spot.

I would accept the fact that producers had contracts with pipelines which in many cases required pipelines to pay for gas that could not be marketed at a profit.

Many of the pipelines wanted to retain those contracts because of their firmness of value. Pipelines in order to retain those contracts and remain in the merchant role had to have a system of payments, and one of the things that they could do is charge their customers for a firmness charge.

Now, clearly, if the pipeline is paying $2 for gas and its competitor is paying $1.50 and the customer is free, the pipeline is not going to sell gas. But if the firmness charge is worth a half a dollar to the customer and the pipeline can charge a half a dollar for firmness, then the pipeline can sell the gas it pays $2 for for $1.50, and it receives the other 50 cents, then, in the firmness charge.

I would not characterize what we were doing as driving the price of gas down. I would characterize what we were doing was allowing the pipeline company as a merchant who had some firm contracts it wanted to hold to survive as a merchant.

And I would also emphasize—and this is a point that I think has not been adequately recognized—pipeline merchants today are in a competitive business. They are increasingly bit players. I think their bit is going to shrink, and I think to the extent that the

FERC tries to impose any constraint on pipeline companies as merchants that the market does not impose on the non-regulated merchants, then the only way the pipeline company as a merchant will survive is if he can extract some of the monopoly power out of the pipeline company as a transporter, and doing that violates everything we have been trying to do for five years.

Senator BINGAMAN. I will defer to some of my colleagues here to ask questions. Senator Nickles.

Senator NICKLES. I might just ask—I have several questions, Mr. Chairman, and I will try and be brief. I also want to apologize to the Commission members for our absence both with the votes and an important conference that we had as well. What is the status?

Ms. HESSE. Of interim gas inventory charges?

Senator NICKLES. Yes.

Ms. HESSE. Well, I would say that in Order 500 we proposed a formula, a policy if you will, for permanent gas inventory charges, and it is, I believe, the hope of each of the members of the Commission that we eventually have permanent gas inventory charges. That is our goal.

The purpose of an interim gas inventory charge was to provide some short-term quick release on an interim basis while the permanent gas inventory charge was being processed. That was the purpose.

Now, the status. We have closed the comment period; we have received the comments from interested parties; we have analyzed those comments; we have prepared a comment summary. I hope that certainly by the end of next month or perhaps the first meeting in November that the Commission as a body will review the proposed policy statement on interim GICs.

In the meantime, we are processing and I hope offering permanent gas inventory charge certificates to pipelines.

Senator NICKLES. You mentioned the summary. I would like to have the summary of the comments, if you would. I think that would be informative, just for the record.

Most of the comments I have heard have been quite negative. Have most of the comments you have heard been quite negative?

Ms. HESSE. I think most of the comments are split, as with almost everything that we do.

Senator NICKLES. Who is in favor of it as proposed with the spot reference?

Ms. HESSE. The Natural Gas Supply Association which represents 90 percent of the gas produced and marketed in this country.

Senator NICKLES. The Natural Gas Supply Association——

Ms. HESSE. Is in favor of interim gas inventory charges.

Senator NICKLES. As proposed?

Ms. HESSE. Both competitive and deficiency-based. I have a copy of their comments.

Senator NICKLES. From Nick Bush and that group?

Ms. HESSE. But I will submit that for the record.

[The material referred to follows:]

NATURAL GAS SUPPLY ASSOCIATION

1129 20th Street N.W.
Suite 300
Washington, DC 20036
(202) 331-8900

James A. [illegible]
Chairman

Nicholas J. Bush
President

Patricia A. Hammick
Vice President

89 JUL 14 AM 10:45

July 14, 1989

HAND DELIVERY

Honorable Lois D. Cashell
Secretary
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Room 3110
Washington, D.C. 20426

Re: Docket No. PL89-1-000

Dear Ms. Cashell:

Enclosed for filing in the above referenced proceeding are an original and fourteen copies of the "Initial Comments of the Natural Gas Supply Association."

Please file stamp the extra copy of this document and return it to our messenger. Thank you for your consideration.

Sincerely,

Nicholas J. Bush

Nicholas J. Bush

Enclosures

89 JUL 14 AM 10:46

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Interim Gas Supply Charges)
and Interim Gas)   Docket No. PL89-1-000
Inventory Charges)

INITIAL COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION

As provided in the Notice of Proposed Policy Statement ("Proposed Policy Statement"), issued by the Federal Energy Regulatory Commission ("Commission") in the above-captioned docket on May 30, 1989, and then amended by the Commission's order of June 27, 1989, the Natural Gas Supply Association ("NGSA") hereby files its initial comments and states as follows:

I

NGSA is an association whose membership comprises both major and independent producers and marketers of natural gas. Approximately 90% of the natural gas produced and marketed in this country is produced by NGSA member companies.

Communications regarding this docket should be sent to:

Nicholas J. Bush, President
Natural Gas Supply Association
1129 20th Street, NW, Suite 300
Washington, D.C. 20036-3403
Phone: (202) 331-8900

II

GENERAL COMMENTS

The questions accompanying the Proposed Policy Statement often delve deeply into the specifics of interim and permanent gas inventory charges ("GICs"). Those specifics will be discussed later in this filing. At the outset, however, it must be emphasized that the mechanics of a particular GIC are far less important than the Commission's continuing resolve to harmonize these charges with the broader policy objective of maximizing competition in the production, transmission and sale of natural gas. The heart of the Commission's natural gas policy is the development of competitive markets, and the interim GIC proposal is but one measure which can play a part in achieving that goal. In evaluating interim GICs, the Commission must therefore remain constantly sensitive to whether these charges, either singly or in concert with other measures, act to foster competition.

NGSA applauds the Commission's efforts to establish markets in which all merchants have a comparable opportunity to compete. In some markets there has already been significant progress toward the competitive ideal. Increasingly, customers have access to suppliers other than pipelines. Producers too, increasingly have access to customers other than the pipeline merchant. The continued existence and development of these alternatives form the cornerstone of competition and the touchstone for both interim GICs and the Commission's natural gas policy as a whole.

In many markets, however, competition is impeded by an array of barriers, including:

- Improper rate designs that have systematically encouraged firm sales customers to retain unneeded capacity rights which would otherwise be used to provide transportation for gas to other purchasers.
- With regard to pipeline service obligations, a perception among firm sales customers that they enjoy certificate protection as long as they remain sales customers, but lose that protection for whatever capacity they convert to firm transportation.
- Scheduling, balancing, receipt and delivery point limitations and other tariff provisions that place burdens on independent merchants which the pipeline-merchant does not bear.
- Continuing reluctance by many local distribution companies to purchase from nontraditional merchants, for fear that their decision will be second guessed by local regulators.

This list of barriers is not exhaustive, but an examination of these factors demonstrates the difficulties which NGSA members currently face in their attempts to compete as natural gas merchants.

In the cause of establishing competition, a properly structured rate design is a necessary complement to a properly structured GIC. Recognizing this linkage, NGSA generally welcomes and supports the Commission's "Policy Statement Providing Guidance with Respect to the Designing of Rates," Docket No. PL89-2-000 (issued May 30, 1989). The rate design policy statement revitalizes the Commission's commitment both to eliminate methodological biases which have improperly inflated transportation rates and chronically underpriced firm capacity rights, and to make all rates more sensitive to season, priority of service and distance of haul. As an ongoing general matter, and particularly in the wake of the rate design policy statement, NGSA remains hopeful that the Commission will match its endorsement of pro-competitive rate design principles with a resolve to apply those principles rigorously in all pending and future rate cases.

In its rate design policy statement the Commission addresses the pipeline service obligation as it relates to the repricing of services. The pipeline service obligation is also critically important to the imposition of interim GICs. Recalling that the touchstone for evaluating interim GICs is their ability to foster competition, any measure which enables customers to purchase alternative supplies promotes customer exposure to the market. Consequently, NGSA is willing to conditionally accept temporary contract demand ("CD") conversion with rights to recall. See NGSA's answer to Question 10 below. Following the same theme, CD conversions should not automatically be subject to permanent abandonment, as that will assure that few customers if any will subscribe to firm transportation service.

Competition is further frustrated by scheduling, balancing and other transportation terms and conditions which allow pipeline-merchants a vastly greater degree of operational flexibility than is available to other merchants. In addressing these problems the Proposed Policy Statement laudably conditions the availability of an interim GIC upon the deletion of tariff references to take-or-pay crediting. By requiring pipelines to eliminate take-or-pay crediting and to offer open access transportation, storage for third party gas and flexible receipt point authority, the Commission has taken significant strides toward removing the biases which have unduly favored pipeline sales service.

As to customer psychology, an interim GIC which fosters customer choice fosters competition while an interim GIC which suppresses customer choice suppresses competition. By allowing customers to sample market alternatives, an interim period can stimulate demand for non-pipeline supplies, which in turn will give alternative suppliers the market opportunities necessary to develop into full-fledged competitors. If fair opportunity for market sampling is provided, by the end of the interim period customers (and their regulators) will have a firmer basis for establishing their freely chosen long-term supply arrangements, and new marketing entrants will have been given the opportunity to compete as credible long-term suppliers.

On the other hand, a GIC can undermine its pro-competitive potential ~~if~~ it forces customers to make binding long-term commitments before the advent of meaningful competition. Given current market imperfections, if customers were forced to choose a long-term supplier today they would doubtlessly feel compelled to renew their commitments to pipeline system supply. Experimentation will cease; potential competitors will languish; and market experience will be foregone. In short, the competitive environment will wither on the vine.

An interim period is useful therefore if it serves to remove regulatory impediments, mitigate structural barriers and expose customers to competition. However, the very interim nature of the proposed GIC acts as a detriment to establishing the longer term relationships necessary to foster stability in the market. Thus, any interim period should be the shortest term possible. Moreover, at the close of the interim period, the Commission must examine each system to determine (1) whether customers are provided meaningful long-term alternatives at the time they make their purchase commitments; and (2) whether all merchants have access to the system on a basis comparable to that available to the pipeline-merchant. If a pipeline can demonstrate these two conditions, and barring any other inhibition to competition, the price and terms for securing and maintaining supplies would be determined by the market, rather than regulatory fiat. In terms of fostering competition, a successful interim GIC would be a success precisely because it worked in tandem with other Commission policies to create a market where specific regulation of a permanent GIC has become unnecessary.

III

ANSWERS TO ENUMERATED QUESTIONS

Beyond the points raised in the General Comments above, at this time NGSA has nothing further to say in response to Questions 12, 13 and 14. The remaining questions are addressed below.

Question 1: The proposed policy statement details two possible methods for developing an interim gas supply charge and an interim limited term gas inventory charge. The Commission is interested in receiving comments on the two proposals outlined herein, as well as on any other proposal for implementation on an interim basis.

Answer: In the broader context of the Commission's commitment to promoting competition during the interim period, the level and scope of an interim GIC are more important than its method of computation. Both the demand-based and the deficiency-based models carry the potential to encourage the competitive ideal. Depending on market strategy, take-or-pay settlements, existing contracts and other circumstances, individual companies may prefer one type of GIC over another. Those differences aside, either method can be acceptable as long as it is coupled with an emphasis on promoting the transition to competition.

Regardless of the method chosen, if a GIC is to provide a means to enable pipelines to contract and pay for secure, long-term future natural gas supplies, the charge must be flexible enough to accommodate supply arrangements which go beyond traditional take-or-pay payments. Under a properly designed GIC pipelines should be able to recover any prudently incurred cost associated with contracting for and securing its gas supply.

One option would be to allow the customers and pipeline to negotiate the interim GIC rate, considering existing contracts and providing an allowance for future contracts. If a rate cannot be agreed upon, the pipeline could be allowed to set the rate at a level it believes will be reasonable and justifiable. If the cost of acquiring long-term supplies is less, then the pipeline could permanently discount the rate to avoid large refunds. If the cost of acquiring long-term supplies is greater, the pipeline could either increase the rate and allow renominations, or eliminate its sales service upon giving due notice.

Question 2: The purpose of providing a mechanism for an interim gas supply charge, and an interim gas inventory charge, is to provide a means to compensate pipelines for securing long-term natural gas supplies for firm sales customers, and in particular to prevent a reoccurrence of the take or pay problems of the past. Would implementation of either of the methods proposed herein, if coupled with implementation of a permanent gas supply charge and a permanent gas inventory charge, accomplish those objectives?

Answer: NGSA understands that one of the principal purposes of a GIC is to provide a financial basis for pipelines to contract and pay for secure, long-term future natural gas supplies, and thus avoid a recurrence of the take-or-pay problems of the past. By definition, however, the proposed interim GIC limits supply arrangements to a maximum term of two years. Due to their interim nature, therefore, interim GICs cannot further their intended purpose on any long-term basis. More permanent solutions should therefore be developed as quickly as possible.

In addition to funding long-term supply, a properly designed GIC must achieve several additional objectives if it is to promote the development of a competitive natural gas market. Specifically, a GIC also should:

- Promote responsible purchasing practices by pipelines and their sales customers;
- Require sales customers to decide how and from whom they will buy firm supplies; and
- Provide market signals indicating the demand for long-term supplies, so producers can obtain the investment capital necessary to explore and develop adequate gas supplies for the future.

The danger in Question 2 is the implication that interim GICs serve only limited policy objectives. To the contrary, interim GICs must reflect these additional, pro-competitive objectives if they are to serve the broader aims of the Commission's natural gas policy.

Question 3: What effect would implementation of either method have on a pipeline's ability to market gas and on the purchasing practices of LDCs?

Answer: Method I (The Competitive Price Method) would make the price that pipelines charge for gas a spot price plus a premium (which may ultimately move above or below a pipeline's WACOG). Method II (The Deficiency Charge Method) would probably have varying results because of the wide range of existing WACOGs among pipelines--as has been demonstrated, if a pipeline can get its WACOG down to a low enough level, its customers will willingly sign up for this type of GIC. In the broader sense, the ability of a pipeline to market gas, and the willingness of LDCs to alter their purchasing practices, may depend more on the level of the GIC relative to the costs of alternative supplies and the perception regarding associated rights (such as the certificated service) than on either methodology.

Where they approximate market-driven prices for secure supply, gas prices including interim GICs can have a dramatic effect on the purchasing practices of LDCs. The current purchasing plan of many LDCs calls for purchasing most of their base load requirements on the spot market and using pipeline purchases for emergency and peaking requirements. Both proposed GICs will encourage LDCs to procure larger portions of their gas supplies through firm contracts, rather than continuing to trade on the spot market while using the pipeline as an unrecompensed safety net.

Under either interim method, LDCs which decide to remain full or partial sales customers of a pipeline will have a financial incentive to take a higher level of pipeline sales gas. This incentive is particularly strong under the deficiency charge method. Facing an incremental GIC cost for every unit of shortfall, LDCs would be likely to make sure that they reach their 60% take level before looking for other supplies of gas. Until this threshold is reached, an alternative supplier cannot compete unless it can offer savings which more than offset the deficiency charge.

Of equal importance, under either interim method LDCs will be unlikely to convert from sales to transportation on a large scale if permanent abandonment of sales entitlement is required. The decision to remain a sales customer or to convert to firm transportation should be based on the level and type of a pipeline's permanent GIC. Nevertheless, as stated in the General Comments above, conversions during the interim period are a primary means for exposing customers to the benefits of a competitive market. As a consequence, during this interim period it is imperative that the Commission avoid any measure, including abandonment, which discourages customers from testing the market.

Question 4: The competitive pricing method for the interim gas supply charge uses 75% as an estimation of a reasonable take or pay level to assign to the pipeline's inventory of contracts. The rationale for doing so is outlined herein. Parties should address whether that level is appropriate. Commenters suggesting another level should specify their reasons for doing so.

Answer: According to page 12 of the Commission's Policy Statement, interim gas supply charges are designed to compensate the pipeline for "the risk of holding gas supply contracts at the same level that the Commission compensates the pipeline for holding its physical assets." Under Method I, the pipeline is supposedly compensated by applying its pre-tax rate of return (e.g., 15%) to an inferred take requirement of 75%, and multiplying the result by the "competitive" gas commodity price.

By asking whether the 75% take requirement is a reasonable overall level, Question 4 rests on the mistaken premise that the rationale behind the Method I calculation is correct. In the first place, a pipeline's rate of return on its physical assets has nothing to do with its gas acquisition costs or risks. Pipelines do not "invest" in a portfolio of gas contracts from which they expect to derive a risk-weighted rate of return. Even if they did, however, the resulting risks would depend not only on the contractual take requirements, but also on the contract prices. A high-take, low price contract might pose no risk to the pipeline whatsoever, whereas a low-take, high price contract might be significantly riskier. In the past the Commission may have allowed pipelines to include take-or-pay prepayments in their cost of service, but today the application of rates of return to inferred take levels no longer bears any relationship to the way the pipelines conduct their business. In the present setting, there is simply no logical nexus between these numbers and the demand component of an inventory charge.

Question 5: The competitive pricing method for the interim gas supply charge ties both the gas commodity price and the gas inventory charge to competitive prices. Would doing so have a positive or a negative effect on long-term gas prices from both a producer's and a consumer's point of view? Further, would doing so have a positive or negative effect on long-term gas supplies?

Answer: Because of its inherently short-term nature, an interim GIC of any kind is less likely to have a dramatic effect on future gas prices or supplies. While interim GICs are in effect, pipelines are likely to use the resulting funds to pay off current and future buyout/buydown costs on existing contracts rather than to underwrite commitments for new, long-term gas supplies. Moreover, pipelines are not likely to sign new purchase contracts that extend materially beyond the term of their interim GICs. Thus, major impacts on future gas prices and supplies will not come until the implementation of permanent GICs.

Question 6: Would implementation of an interim gas inventory charge based on either a competitive price concept or a deficiency charge method affect the rights and responsibilities of parties under existing gas purchase contracts and, if so, how?

Answer: In NGSA's opinion, neither a deficiency-based nor demand-based GIC in any way affects the rights and responsibilities of parties under existing gas purchase contracts. However, as noted in Senator Domenici's letter to the Commission of February 14, 1989, some producers are concerned that a GIC tied to spot prices would encourage or permit pipelines to exercise "FERC-out" or "market-out" clauses in existing contracts.

Unlike the Commission's prohibition on recovering variable costs through minimum bills (Order No. 380 et al.) the GIC does not undermine an LDC's obligation to its pipeline. To the contrary, the very purpose of a GIC is to assure the pipeline that contractual costs are covered, and the pipelines will voluntarily design and choose the GICs they want to employ. It therefore seems unlikely that there can be any justification for a pipeline to exercise a market-out or FERC-out clause on the basis of the GICs proposed by the Commission. Nevertheless, to allay any doubt the Commission should underscore its language at page 6 of the Proposed Policy Statement to make clear that the Commission has no intention either to alter or affect existing producer contract rights or obligations, or to encourage pipeline abrogation of contracts.

Question 7: The deficiency charge method for the interim gas inventory charge has been illustrated with a charge equal to 20% of the pipeline's WACOG applicable only if a firm sales customer's actual purchases fall below 60% of its nominated purchase amounts. The illustration percentages are based on a gas inventory charge proposal approved by the Commission. [footnote omitted] Parties should address whether the 20% and 60% levels are appropriate. Commenters suggesting other levels should specify their reasons for doing so.

Answer: For purposes of implementing an interim GIC, a charge equal to 20% of a pipeline's WACOG, although somewhat arbitrary, may not be unreasonable for some pipelines. In contrast, a low threshold purchase level undermines one of the primary objectives of an interim GIC: the promotion of responsible purchasing practices by pipelines and their sales customers.

A deficiency-based interim GIC should be structured in a manner that is not anti-competitive and does not encumber the transmission of price signals. With the purchase threshold set at 60%, sales customers will be able to purchase spot market supplies above the 60% level without incurring any long-term supply related costs. If those customers' actual usage is consistently higher, the margin of relatively cost-free purchases above the threshold confounds the objective of a GIC. In short, at a charge equal to 20% of WACOG a 60% deficiency level may be too low.

Question 8:	As proposed, the deficiency charge would be based on a flat percentage of a pipeline's current WACOG. Does this type of charge provide a disincentive for pipelines to keep their costs of purchased gas down? Does the deficiency charge method need to have a cap on the WACOG and, if so, how should the cap be determined? Finally, should the WACOG used in developing a deficiency charge be calculated on a weighted average basis for all interstate pipelines?

Answer: Using a pipeline's WACOG to calculate a deficiency-based GIC provides neither an incentive nor a disincentive for pipelines to keep their gas purchase costs down. The pipeline would basically be using the old PGA system to recover its gas commodity costs. Under that system, the only incentives to keep costs down were concerns with the prudence of gas purchases and the conversion of sales customers to transportation. Nothing really changes under a deficiency-based GIC tied to WACOG. There would now be a separate GIC account established to track take-or-pay costs, but because the Commission has never deemed take-or-pay payments to be gas costs the deficiency-based GIC proposal would not alter the pipeline's market responsiveness.

NGSA strongly advises against imposing a WACOG cap on pipelines. Such caps smack of indirect wellhead price controls and would, at the very least, exert artificial downward pressures on natural gas prices--an outcome conceded to be unacceptable by nearly all of the participants in the debate over natural gas decontrol because of the artificial shortages of supply that result.

As to the last part of the question, NGSA believes the WACOG used in developing a deficiency-based GIC should be the pipeline WACOG and not an industry average. By pegging deficiency-based charges to a cost other than a pipeline's own WACOG, a methodology based on industry averages would place a pipeline's total commodity costs at risk, transforming the GIC into one that is partly market-based.

Question 9: Does the proposed reconciliation method adequately protect a pipeline's customers from excessive charges as a result of the interim gas supply charge and interim gas inventory charge? Does it provide an adequate incentive to pipelines to hold down costs, enter into long-term contracts if appropriate, or otherwise file for an interim gas inventory charge?

Answer: In a truly competitive market there would be no need for a reconciliation method. Competitive forces would ensure that a GIC would be set at a level that served its stated purpose, namely, providing a pool of money to provide for long-term availability of gas. However, because current markets are not truly competitive some reconciliation method may be appropriate. Unfortunately, the reconciliation mechanism set out in the Proposed Policy Statement does not promote responsible purchasing practices.

The reconciliation mechanism suggested in the Proposed Policy Statement disadvantages competing marketers since purchases of system supply will always offer the prospect of refunds. In addition, a reconciliation mechanism will not promote responsible purchasing practices on the part of customers. So long as a customer bears no risk for overpaying its GIC, the customer may often be prompted to take the easy way out by accepting the gas which has a potential refund attached to it.

Accepting that current markets are not truly competitive and that certain parties will feel that a reconciliation mechanism is essential to the implementation of a GIC, several changes need to be made to the proposal. First, the reconciliation mechanism should work both ways to encourage customers to make a thorough evaluation of their purchases. Second, refunds should be distributed in a lump sum based upon actual amounts paid rather than credits against future purchases. A lump sum distribution would decrease the likelihood that refunds would affect decisions regarding future purchases by customers. Third, the Commission should refine the type of costs that may be covered by an interim GIC. If the list of eligible costs turns out to be underinclusive, the Commission could expand the scope of coverage when it approves the permanent GICs.

Question 10: Do the proposed conditions regarding nominations and conversions provide sufficient flexibility for existing firm sales customers to make a realistic assessment of their current needs in light of current market circumstances?

Answer: The nomination and conversion procedures provided by the Commission may, in the short term, provide the customers with the needed flexibility to assess current needs, "shop" those needs with alternative suppliers, and then make their choice of a supply portfolio based on that evaluation. There are three necessary components of that flexibility. First, customers must be able to nominate as low as zero firm sales service. Second, purchases from third parties must be transported on the same terms and at the same rates as purchases from the pipeline. Third, customers must not lose their right to contest abandonment of the transport obligation at the end of the contract.

While the Proposed Policy Statement is not explicit on all these points, two inferences can be drawn from the totality of the Statement. To the extent there is any question concerning these inferences, the Commission should clarify its proposed policy to embrace these concepts expressly.

First, the terms applicable to transportation service must be identical to those applicable to the transportation component of the sales service, at least to the extent these terms impact the reliability of delivery. Many of the features often cited as enhancing the "reliability of system supply gas" are really features associated with the transportation of system supply gas. Examples include: the firmness of withdrawals from storage on peak day; the ability to nominate an aggregate (or pooled) supply from which the pipeline will draw--consistently--the volume nominated for purchase by the customer; and the ability to reduce purchases slightly on warmer days and increase them slightly on colder days, with the pipeline meeting these marginal decreases and increases. Under Order No. 436, these elements should be available to customers who opt to purchase from third parties instead of from the pipeline. Equivalence of firm transportation to firm sales has not yet been achieved on any pipeline. For the interim GICs to work--for the customer to have not just the ability but the confidence to rely on third-party supply--such equivalence is vital.

Second, the customer's right to contest the abandonment of the transportation service obligation at the end of the interim period must not be affected by any decisions made during the interim period. This issue is addressed more fully in response to Question 11.

Question 11: Should the Commission consider additional voluntary rights for customers, including conversions of service obligations to interruptible transportation, abandonment or scheduled abandonment of service obligations, or combinations of the foregoing to meet the new market environment?

Answer: In order to reach a new competitive environment, firm sales customers must have an opportunity to convert significant levels of service to firm transportation as provided in Section 284.221(d) of the Commission's regulations. Conversion of all capacity to transportation and the disappearance of pipelines from the marketing end of the business is not required, or even particularly desirable, but there must be at least an opportunity for customers and suppliers to make alternative sales arrangements.

There will be no meaningful competitive alternatives to pipelines as base-load, long-term gas suppliers as long as customers remain wedded to CD sales. To date, many firm customers are not converting to transportation. There may be many reasons for this, including misdesigned sales and transportation rates and the lack of market discipline which results when customers enjoy pipeline service obligations at no charge. One of the major impediments to conversion, however, is the significant difference in reliability of firm capacity between CD sales and converted firm transportation.

In view of their local public service obligations and the scrutiny applied by local public utility commissions, customers will be unwilling to convert as long as a possibility exists that firm transportation capacity might be lost. The fact that less than 10% of firm sales have been converted to transportation in the years since the issuance of Order No. 436 demonstrates that this reluctance is quite real. The Associated Gas Distributors underscored these sentiments in a motion to the Commission filed in the Order No. 500 docket on November 7, 1988, which requested that the Commission amend its regulations to eliminate pregranted abandonment for converted firm transportation. It has become clear that the new market environment envisioned by the Commission cannot arise as long as there remains such a dramatic difference in the reliability of CD sales and firm transportation.

NGSA urges the Commission to address this very significant problem by limiting pregranted abandonment for converted transportation to instances of agreement between a pipeline and its customers. Where the parties agree, pregranted abandonment of converted transportation is an efficient and rational device permitting reallocation of scarce pipeline capacity with the least fuss and bother. Where the parties do not agree, however, firm customers must be assured of the continued availability of firm capacity. If customers cannot get that assurance of firm transportation entitlement they will maintain it through continued allegiance to pipeline sales, and the Commission's efforts to impose market discipline on the industry may well be stillborn.

Question 15: Should the Commission limit or prohibit extensions of an interim gas inventory charge in order to provide incentives for pipelines and their customers to put permanent gas inventory charges into place by the end of the two-year period?

Answer: At this early stage of the proceedings the emphasis should rest on the appropriate objectives and design of interim GICs, rather than the somewhat academic question of whether and under what conditions these interim measures should be extended. While acknowledging that permanent GICs should be implemented, the merits of extension are too tenuous and case-specific to be examined effectively in these initial comments.

Question 16:	One alternative to the two methods proposed in this Notice would be to allow any pipeline to file tariffs immediately, pursuant to Section 4 of the Natural Gas Act, to implement an interim GIC of 35 cents per MMBTU, for deficiencies below 80% of the volumes nominated, subject to refund. The amounts paid would be added to the PGA. The case would go to hearing on an expedited basis to determine the just and reasonable rate for a permanent GIC. Would this method work? Would it be preferable to the other two methods? Would consumers be protected under this proposal?

Answer: The adequacy of the suggested GIC (35 cents per MMBTU) or any other rate will depend on the circumstances of the particular pipeline. Because the proposed alternative is a deficiency-based GIC (albeit one with a higher take requirement than Method II) it may not be acceptable to those pipelines and customers desiring a demand-based GIC. One clearly objectionable aspect of this proposal is that the GIC charge is triggered by deficiencies below 80% of volumes nominated. Only customer CD, not nominations, should be the basis of a GIC charge.

IV

CONCLUSION

WHEREFORE, as the Commission contemplates the imposition of interim gas inventory charges, the Natural Gas Supply Association respectfully urges the Commission to recall the broader and more fundamental objective of fostering a truly competitive natural gas market. Keeping that broader objective firmly in mind, the Natural Gas Supply Association respectfully requests that the Commission embrace the comments and respond favorably to the requests for clarification and modification presented herein.

Respectfully submitted,

Nicholas J. Bush, President
Natural Gas Supply Association
1129 - 20th Street, N.W.
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Washington, D.C. 20036-3403

July 14, 1989

NATURAL GAS SUPPLY ASSOCIATION

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REGULATORY
COMMISSION

August 14, 1989

HAND DELIVERY

Honorable Lois D. Cashell
Secretary
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Room 3110
Washington, D.C. 20426

Re: Docket No. PL89-1-000

Dear Ms. Cashell:

Enclosed for filing in the above-referenced proceeding are an original and fourteen copies of the "Reply Comments of the Natural Gas Supply Association."

Please file stamp the extra copy of this document and return it to our messenger. Thank you for your consideration.

Sincerely,

Patricia A Hammick for
Nicholas J. Bush

Enclosures

Representing the Nation's Producers of Natural Gas

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Interim Gas Supply Charges and Interim Gas Inventory Charges	)))	Docket No. PL89-1-000

REPLY COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION

As provided in the Notice of Proposed Policy Statement ("Proposed Policy Statement"), issued by the Federal Energy Regulatory Commission ("Commission") in the above-captioned docket on May 30, 1989, and then amended by the Commission's order of June 27, 1989, the Natural Gas Supply Association ("NGSA") filed its initial comments on July 14, 1989. More than one hundred parties filed initial comments with the Commission which represented viewpoints of all aspects of the industry. NGSA appreciates the extension of time granted by the Commission which has allowed it and its members to respond to these comments. NGSA hereby submits its reply comments and states as follows:

I

NGSA is an association whose membership is comprised of both major and independent producers and marketers of natural gas.

Approximately 90% of the natural gas produced and marketed in this country is produced by NGSA member companies.

Communications regarding this docket should be sent to:

Nicholas J. Bush, President
Natural Gas Supply Association
1129 20th Street, NW, Suite 300
Washington, D.C. 20036-3403
Phone (202) 331-8900

NGSA finds among the comments filed a strong consensus on several aspects of Gas Inventory Charges (GICs). The Commission should take that consensus to heart and respond as expeditiously as possible to the need for GICs on all merchant interstate pipelines. Specific areas of consensus are highlighted herein.

II

A. Creative means must be employed to implement GICs quickly.

NGSA supports AGA, INGAA and numerous other parties that state GICs should be implemented quickly. NGSA also supports the many parties that emphasize the need to establish a competitive environment for GICs in order to give customers true open access to firm supplies. We again commend the Commission for its efforts through this notice of proposed policy statement, with its competition-enhancing conditions, to attempt to accomplish these goals.

Pipelines continue to propose creative means to quickly implement GIC-like programs, many of which are named or described as if they were not, in fact, gas inventory charges. Those filings must comport with the gas inventory charge requirements of Order No. 500, and the final policy statement on GICs in order to accomplish the goals of a speedy development of a stable competitive gas market.

NGSA supports the Commission's use of the most expeditious process available to put these GICs in place, be it through the current certificate proceedings or rate proceedings (subject to refund) or some combination thereof. GICs will support the recovery of future take-or-pay and, more importantly, provide experience in the use of such charges as market signals. NGSA believes that, assuming competitive alternatives are available, a "negotiated" GIC should be placed in effect quickly on at least a test or an interim basis.

B. Firm supply alternatives must have transportation that is on an "equal footing."

NGSA supports the numerous comments that firm transportation must have "equal footing" with the transportation included in firm sales service. Such transportation is critical to providing the customer with viable long-term supply alternatives. The existence of such alternatives will aid the customer in evaluating and requesting the new level of service to which the GIC is attached. The Commission should require that all firm transportation performed, whether for the pipeline merchant's gas or another supplier's gas, be subject to the same terms and conditions.

C. The Commission should clarify terms relating to nominations and CD levels.

Many commenters seemed confused over the term "nominations" and over the basis upon which the GIC would be calculated. Historically, the CD level represented the maximum daily contract level that the customer could call for, and that the pipeline could be required to provide.

The term "nominations" has been used as either the basis for D-2 charges (related more to pipeline capacity, not gas supply) or for scheduling. In neither case was it used to establish a charge for maintaining an inventory of gas supply. Moreover, in neither case did it establish a ceiling for the customers' right to purchase gas. Purchases in excess of nominations have been commonplace, and the pipeline has been obligated to provide that excess gas up to the CD level.

The interim proposal provides for customers to "nominate" a level of purchase upon which a GIC will be assessed. This creates the potential for what appears to be a "new CD" level.[1] It may also create the potential for monthly or even daily scheduling calls. The proposed policy is unclear on what the GIC will be based: "the newly elected CD" or the scheduling call.

NGSA asks the Commission to clarify this issue, and to provide that the GIC be assessed against the customer's newly elected CD - and that this level be the maximum obligation of the pipeline to supply gas to that customer. It is the maximum obligation upon which the pipeline must base its available inventory, to be ready to supply calls for gas in excess of nominations should they come.

Having established the CD as the basis for the GIC, the Commission should find that many commenters objecting to abandonment of CD above nominations would be satisfied, as the abandonment would relate to the level above which the customer has said it would never purchase from the pipeline.

IV

CONCLUSION

As the Commission contemplates the imposition of interim, "test period" or permanent gas inventory charges, NGSA respectfully continues to urge the Commission to focus on the objective of fostering a truly competitive natural gas market. NGSA asks the Commission to respond favorably and quickly to the comments supporting implementation of competitive GICs and to the comments and request for clarification presented herein.

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[1] In its initial comments, NGSA supported the use of a temporary CD with right to recall. Given the interim nature of the GICs initially contemplated by the NOPR, NGSA recognizes that the customers should have the right to select a new CD level upon implementation of a permanent GIC.

Respectfully submitted,

Patricia A Hammil for

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Washington, D.C. 20036-3403

August 14, 1989

Senator **Nickles**. I appreciate that.

Who else supports it?

Ms. **Hesse**. I think that people or parties in general are supportive of the concept of an interim gas inventory charge.

Senator **Nickles**. Well, I could be if it was designed correctly, but I am not going to be in favor of one that has a result of basically reregulating or driving down the gas prices artificially by FERC action.

Ms. **Hesse**. No one on this Commission would be in favor of that. What the proposed policy statement included was a number of different ways to compute an interim gas inventory charge, and we asked for comments on these various ways.

I think many of us believe that there are merits in different types of interim as well as permanent gas inventory charge proposals. I, in fact, have voted on two different kinds, both deficiency-based and competitive markets. That is why we put out the proposed policy statement, to receive comment, to review it, and then to sort of factor it into our final deliberations. We have not reached that step yet.

Senator **Nickles**. What was the—I am not going to say conclusion, but there is probably some variance—but what do most of the pipelines think of the proposal?

Ms. **Hesse**. I think—well, first of all, let me say that we should supply these specific comments for the record. I believe that the response of the pipelines was generally yes, we are in favor of interim gas inventory charges. Perhaps different ones for different pipelines.

There are certain basic factors that they want. They want it to be fair to them, they want it to be in effect right away, and they want it to be based on settlements. They want the Commission to agree to approve settlements regardless of whether they are competitive based or deficiency based.

Senator **Nickles**. Has the Commission made a decision as far as whether it will be competitive based or deficiency based testing?

Ms. **Hesse**. We have not.

Senator **Nickles**. Is there a consensus today which way you would go?

Ms. **Hesse**. Well, each can speak for himself or herself, but I think that certainly a majority of us believes that there can be different gas inventory charge proposals that are suitable to a particular pipeline. And, as I just said, we have two permanent ones that we have issued. One was a competitive based and the other was a deficiency based. I voted for both.

Senator **Nickles**. So, would it be your intention to do it on a case-by-case basis?

Ms. **Hesse**. Yes, and that was the intent of Order 500 as well.

Senator **Nickles**. I will ask Commissioner Stalon as well or anyone else on the Commission—is it your intent or desire through this GIC to reduce wellhead prices?

Mr. **Stalon**. No. It is my intent and desire to bring together an efficient system of communication for buyers and sellers so that that market is efficient.

It is not my objective to have a particular portfolio of prices. It is not my objective to have high or low prices. It is my objective to create a market where the preferences of buyers and sellers as constrained by the the state of nature produces efficient results.

Senator NICKLES. Is it your opinion that the result would be to reduce gas prices?

Mr. STALON. Compared to what? Compared to a competitive market?

Senator NICKLES. Yes.

Mr. STALON. No. My view is that pipelines as merchants are relatively small players. They are going to shrink. They are going to accept prices in the market. Any attempt by——

Senator NICKLES. Compared to today's market?

Mr. STALON. Today's market? No. My view is that if we had not done something to help the pipelines adopt a GIC, we would merely have accelerated their exit from the gas merchant role.

They simply——

Senator NICKLES. What is so wrong about that?

Mr. STALON. Nothing.

Senator NICKLES. You have a major movement, as you stated in your statement and the chairman stated in her statement, that the gas pipelines for the last several years have already been moving from the merchant basically to transporters. So, why should we enact a GIC?

Mr. STALON. I have no objection to the pipelines withdrawing from the merchant business. There are, however, many players out there who want pipeline companies to continue as merchants.

I feel in that context I have an obligation to try to make it possible for the pipeline companies to continue as merchants and a necessary ingredient for the pipeline to continue as a GIC.

Senator NICKLES. And you think a GIC should be based on quotes by prices?

MR. STALON. I have never committed myself to that point, but I have, however, committed myself to two points that are close to that. I have committed myself to the view that a demand price GIC that is a competitive price GIC is distinctly superior to an deficiency-based GIC.

And the second thing I have done is to recognize that in the competitive market pipelines will not be able to sell gas at a price higher than that which competitive, non-regulated merchants are selling when customers have the ability to pick and choose.

If competitive markets are going to sell at a spot price, the pipeline must be prepared to sell at a spot price or lose that market.

Now, I would expect——

Senator NICKLES. It sounds to me like, Commissioner, you are really making an effort to move all prices to spot prices.

Mr. STALON. I am not making any such effort at all. I am trying to let the buyers and the sellers communicate efficiently and have the middleman serve those interests at both ends.

Senator NICKLES. For pipelines that have weighted average gas cost, as all do in excess of spot prices, what happens to those contracts and those pipelines if you declare spot prices as just and reasonable? Anything above spot prices are not just and reasonable so, therefore, those pipelines would be subjected to—well, I guess they would have the opportunity, then, to abrogate those contracts?

Mr. **Stalon**. I think there is a two-part argument here that must be kept separate. The chairman has made it very clear, and I think it deserves great emphasis, that the price at which the pipeline sells in terms of the variable commodity and the price at which it buys are two separate, conceptually separate ideas.

And if the pipeline chooses to sign a contract with a producer, a contract which Congress has told us we have no business getting involved in, if the pipeline chooses to sign a contract for $2 an mcf, that is the business of the pipeline and the producer.

On the other hand, if the merchants that are non-regulated can compete for the business and can sell it for $1.50, then that pipeline must be selling some other service, and that other service is going to have to be firmness security, and it is a price on security that we are debating.

Now, it is the business of the pipeline and the producer to decide how that firmness charge will be divided up between the pipeline as a risk bearer and the producer as a supplier of gas.

You have told us to stay out of that, and I think that is proper. I think we ought to stay out of that. But we have an obligation—I think we have an obligation—I have asserted we have an obligation—to make sure that as long as there is a strong demand for the pipeline company to play the merchant role, we allow the construction of rate designs that will allow him to survive in that role. And, in order to do that, he has got to have a GIC. He has got to have a GIC.

Senator **Nickles**. Well, the GIC could be added on, or it could be built into a commodity price.

Mr. **Stalon**. I agree, but the point is the pipeline will not have any monopoly power. So, whatever he does, it has to be within the constraints of a tightly competitive market.

Senator **Nickles**. I have a lot of questions. Let me just make a comment first. The so-called spot market price—and correct me if I am wrong—but it is not, in fact, a spot market price. The way you propose in your gas inventory charge proposal to calculate it, in my opinion, is artificial and bordering on the arbitrary and capricious standard. Do you agree with that? Do you not end up selecting spot gas price and determining spot gas prices by what, monitoring for periodicals or journals and determining spot gas prices in that way?

Mr. **Stalon**. I would have to say spot price is a competitive price. It is the competitive price.

Senator **Nickles**. There is a difference between spot price and contract price, is there not?

Mr. **Stalon**. I agree. There is.

Senator **Nickles**. There is a big difference in spot price in my state in one end of the state and gas fields in the other end of the state.

Mr. **Stalon**. That is exactly right.

Senator **Nickles**. And I have a problem, if you have not figured it out yet, Commissioner Stalon. I have a problem with the Commission trying to come in and dictate that we are going to have a GIC and set as one way or another, basically, the gas prices.

Mr. **Stalon**. I guess I did not understand that. I am sorry.

Senator **Nickles**. Well, we have had a problem understanding each other for a couple of years now.

Mr. Chairman, I will pass for Senator Domenici.

Senator **Bingaman**. Senator Domenici.

Senator **Domenici**. Thank you, Mr. Chairman.

Mr. Chairman and members of the Commission, first, I want to divulge a bit of my own history as it involves what you are trying to do. I think when we failed up here in the first effort some three years ago at deregulation, we got hung up on abrogation of contracts and a number of issues of that type, freedom of transmission, and we had take-or-pay out there in spades.

I think I was the first Senator that said we cannot solve it. The Commission had better try. I am not sure you were all on the Commission then, but surely a couple of the Commissioners were here, and I think one of you was on the Commission.

I was serious about that. I did not see how we could fix that, and I did not see how to resolve the build-up—I am speaking now of the past, the back build-up—unless you figured out a way. And I compliment you, you did.

Now, having said that, I have been a staunch advocate of paying some premium for supply. That is what all this take-or-pay was back yonder. That was a guarantee that you had supply.

It turned out prices changed dramatically, and we had pipeline companies who were not in such a minor position as they are now. Actually, they are now merchants of a small amount. But, they were the merchants of a very large percent at that point.

We did not have the negotiation with the producers and the LDCs. That is a recent phenomenon. And so, I have been searching, as you have, for something to happen in the marketplace that was not as crazy as some of the Commissions around the country pushing this whole natural gas policy toward spot market; no contracts. They have succeeded. That is what has happened.

Having said that, I only tell you that because I may appear a bit chagrined at what you were doing today, but I think we are all searching. But I have a very difficult time and maybe either one of you or two of you could tell me one more time. I do not understand at all.

I got a little glimpse from your last remarks, Commissioner, but I do not understand how you can take a spot market GIC and apply it to a pipeline for their merchant capability.

The aspect of the delivery that is their merchant activity, I do not see how you can set that and call it spot, and call it an assurance for the LDC to know what they have to pay. And it will increase supply—which is what you really wanted, long-term supply. I do not see how you can have that with your explanation that the price can be substantially different on this end of the pipeline than what you have set for delivery at this end.

If I read you right, you are saying so be it. It will get worked out. How?

I mean, it seems to me that what it really does is to say on this end of the pipeline, the producer pipeline, you take this new price or you keep your gas. And I assure you that it is my legal opinion that if you use in a GIC the words "just and reasonable" which is in one of your proposals, I do not see how the producer on this end has even a legal standing to sell at anything other than through the pipeline as merchant at the price you have established in this formula.

Maybe you can refresh me on how if you have no authority to set just and reasonable prices and yet if you use those words it seems at this end of the pipeline as no way that they are by force majeure out of their contracts, and that is pushing the price down through your actions and establishing a single price.

I do not know what else could be price control other than that. So, maybe I do not understand from the economic standpoint. I understand, Commissioner, that you are an economist. I mean, your rationale makes no sense to me.

How long can a pipeline and I am talking to Commissioner Stalon—I am looking him right in the eye and so I guess he knows—how can they continue to sell on this end of the pipeline for a lower price than they are paying the producer; than the producer wants to get on this end without going broke all in the name of having an inventory charge create more gas on this side? I do not understand that. It seems backward to me.

Maybe your answer would be yes, they will go broke.

Mr. STALON. It is very clear. They cannot buy at a higher average price than they sell for any sustained period of time. We are all agreed on that.

Senator DOMENICI. Then is that relevant to this?

Mr. STALON. I think it is relevant.

Senator DOMENICI. So, which do you want to go broke? Do you want the pipeline to go broke or do you want the producer to abrogate his contracts?

Mr. STALON. The objective that the Commission has endorsed—and I believe I have been persuaded legally it must endorse temporarily—is it must seek to buy and sell at identical prices on the average. That is an objective which we have interpreted as a part of the just and reasonable requirements.

And I think our dilemma can be described in these terms. We have no voice—properly so—in deciding what premium the pipeline will pay to the producer. He may pay a spot price plus a premium. We have no voice in that.

We are, however, under law required to establish a price at which the pipeline merchant sells that is just and reasonable. No matter what price we establish, whether it be super high or super low, it must be labeled just and reasonable under the definition of the law and its traditions. That dilemma is real. That is a reality of the circumstance.

What we have tried to do——

Senator DOMENICI. So, let me just ask. Are you suggesting, then, that in the imposition of a GIC that you had legal authority under the Natural Gas Policy Act to find as just and reasonable any purchase amount other than that which the pipeline actually pays?

I mean, I read you to say that is what must actually permeate your GIC, and I do not understand that you have authority to set just and reasonable prices on the producer. In fact, I think you are prohibited.

Mr. STALON. I agree. We do not have any authority to evaluate the price at which pipelines produce or buy gas from producers except under certain fraud standards. But, we do have an obligation to declare the price at which the pipeline merchant sells gas as being just and reasonable.

Now, if you draw the logical deduction that the declaring of one is a declaring of the other, then we do have a true dilemma.

Senator DOMENICI. I tell you, I really fail to understand how any sustained period of time there can be any distinction between the two. They will come together just as certain as day follows night, and it will be because you have put the pipeline in the position and the LDC on the other end saying that is all we are going to pay.

Now, you put all these producers in line over here, and you think that they are going to be able to say that is not the right price. I have got contracts or whatever it is for any sustained period of time and if the answer is no, you have determined the price all in the name of producing sustained supply.

Mr. STALON. I think we must draw a distinction between a market in which the pipelines are bit players versus markets in which they are dominant players. If the pipeline was a dominant player and it had monopsony power in the markets in which it purchased and monopoly power in the markets in which it sells, then I would agree that the dilemma that you are emphasizing would be a painful one.

But if the pipelines are bit players in the market buying gas, that price will be determined to some extent independent of their actions, and they will have to pay whatever is necessary to obtain the gas.

Their choice will be the portfolio. They can buy some on spot, some on short-term, some on long-term and that each pipeline merchant, as every other merchant, will be mixing his portfolio. And our job is to see that the pipeline company as a merchant facilitates competition and survives as long as he wants to.

Senator DOMENICI. Mr. Chairman, I will submit the rest of my questions for the record, but I would submit at least my own observation that while I am having a great deal of difficulty understanding how any of the GICs they have recommended are going to accomplish what they started out intending, I can say that if I believe Commissioner Stalon's last remarks, then I am very worried about New Mexico because if there is ever a state that is dominated by the pipeline distribution system, it is ours.

And I am not angry at anyone. It just happens to be the case even though as a result our prices are the lowest already. We have been beat about the head because we do not have any opportunity to do much else. So, if for no other reason, it seems to me very, very significant that we not have an additional price hammer affixed to pipelines in situations of the type I have described.

On the other hand, I do not see any GIC you have proposed yet—and maybe you have suggested that the latest negotiations between the independents and the Transco that they have submitted as their supplemental application—maybe you are talking about approving that. That is one where they have agreed. They have agreed here in the middle and on this end and left the producer out. And perhaps you are looking at that situation on a case-by-case basis. It is the only one that comes close to being right from what I could see, and I understand you have trouble with that, some of you.

Thank you, Mr. Chairman.

Senator **BINGAMAN**. Thank you. I understand we have got about five minutes left before our vote is closed, and you folks have some planes to catch. We appreciate very much the attendance of the Commission today.

There may be some additional questions we will submit in writing.

Thank you all very much.

[Whereupon, at 12:10 p.m., the hearing was adjourned, subject to the call of the Chair.]

APPENDIXES

APPENDIX I

Responses to Additional Questions

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

CHAIRMAN

October 10, 1989

Dear Mr. Chairman:

Thank you for your letter of September 20, 1989, enclosing post-hearing questions pursuant to the September 14 oversight hearing on Gas Inventory Charges held by the Senate Energy and Natural Resources Subcommittee on Mineral Resources Development and Production.

I appreciate your interest and am pleased to forward the enclosed responses prepared by the Commission staff to your questions as well as those submitted by Senators Ford, Nickles, Domenici, and Wallop. My responses do not reflect the views of my colleagues on the Commission, which may be submitted to you under separate cover.

If you have any further questions or need additional information, please let me know.

Sincerely,

Martha O. Hesse

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
  Development and Production
Committee on Energy and Natural
  Resources
United States Senate
Washington, D.C. 20515

QUESTIONS FOR THE RECORD FROM SENATOR BINGAMAN

Question 1(a): Attached is an analysis performed by the Energy Information Administration of the Department of Energy which compares natural gas spot market prices with the weighted average cost of gas for 20 major interstate natural gas pipelines. It has been asserted that this analysis demonstrates the impact that the Commission's proposed policy on gas inventory charges would have on producers.

(a) Does the EIA analysis present an accurate depiction of the likely impact that the Commission's proposed GIC policy would have on producers? Please explain you answer.

Answer: The EIA calculations presented in Tables 1A - 3B do not demonstrate the impact that the Commission's proposed GIC policy would have on producers. Rather, these calculations constitute an arithmetic exercise that, in the words of footnote e to EIA Table 1A, show "...the difference in revenue producers would have received if the pipeline had been able to buy the same volume entirely at spot market price levels rather than at prevailing long-term contract price levels." Despite the fact that a GIC, whether competitive-priced or deficiency-based, provides pipelines with a means of recovering gas costs above current spot levels from their customers, if warranted, the tables include no amount for these potential revenues. Again quoting footnote e from Table 1A, "These calculations ignore any other changes to spot or contract price levels that might have occurred as a result of such actions."

EIA's calculations show that spot market prices in 1988 were generally lower than the pipelines' weighted average cost of gas. This is hardly surprising in view of the fact that spot prices have been declining and that the WACOG is closely related to an average of past prices. It is this very price differential which has encouraged so many of the pipeline's traditional sales customers to abandon pipeline purchases in favor of spot market purchases. The Commission's competitively-priced GIC is a direct response to this market development. Under the proposal, pipelines would be able to compete with the spot market and simultaneously recover additional revenue in a demand charge to compensate producers who dedicate long-term reserves.

Question 1(b): Has the Commission performed any independent analysis of the likely producing sector impact of its proposed GIC policy?

Answer: Yes. We have built on the information provided by the EIA, to provide rough estimates of the possible impact of GICs on producers' revenues under different hypothetical conditions. What will in fact happen, however, depends far more on future and unpredictable market conditions, than it does on any Commission actions.

An important missing element from the EIA Tables is the GIC demand charge. The tables merely estimate the revenue from a volumetric charge (the yearly average spot price). If the spot market based (or competitive-priced) GIC plan were implemented, it would include a demand charge, commonly called a GIC, charged against the customers' firm entitlements, which will be referred to below as the "GIC basis." Thus, the EIA tables do not contain a crucial portion of the competitive-price based GIC implementation -- the Gas Inventory Charge itself.

Tables 1Aa and 1Ab below improve upon EIA Table 1A, because they include estimates of the spot-based GIC demand charge. Columns labeled (A) - (G) are the same as the corresponding columns in EIA Table 1A. Columns (H) - (K) are new. They contain estimates based on the Competitive Price Method described in the Notice of Proposed Policy Statement.

TABLE 1Aa -- If "Volume" (Column B) is 75% of GIC Basis

(A)	(B)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	1988 WELLHEAD PURCHASES			WELLHEAD AVG vs SPOT DIFFERENCE:			ADDING THE GIC DEMAND CHARGE		
Pipeline Name	Volume	Weighted Average Price	1988 Avg Spot Price	in Price (E-D)	in Revenue (F*B)	Revenue for Gas at Avg Wellhead (D*B)	Demand Charge (.15*.75 *E*B)	Revenue Difference (F*B + I)	Percent Revenue Difference (J/H)
ANR	168	2.14	1.62	-0.52	-87.36	359.52	40.82	-46.54	-12.9%
CIG	157	1.52	1.47	-0.05	-7.85	238.64	34.62	26.77	11.2%
Columbia	361	2.31	1.66	-0.65	-234.65	833.91	89.89	-144.76	-17.4%
CNG	82	2.84	1.74	-1.10	-90.20	232.88	21.40	-68.80	-29.5%
El Paso	201	1.76	1.58	-0.18	-36.18	353.76	47.64	11.46	3.2%
Fla GT	147	1.99	1.70	-0.29	-42.63	292.53	37.49	-5.15	-1.8%
KN	64	1.63	1.53	-0.10	-6.40	104.32	14.69	8.29	7.9%
Natural	132	2.05	1.64	-0.41	-54.12	270.60	32.47	-21.65	-8.0%
Northern	369	1.45	1.64	0.19	70.11	535.05	90.77	160.88	30,1%
Northwest	90	1.94	1.48	-0.46	-41.40	174.60	19.98	-21.42	-12.3%
Panhandle	69	2.29	1.60	-0.69	-47.61	158.01	16.56	-31.05	-19.7%
Southern	149	2.28	1.66	-0.62	-92.38	339.72	37.10	-55.28	-16.3%
Tenneco	349	1.85	1.66	-0.19	-66.31	645.65	86.90	20.59	3.2%
Texas Eas	599	1.76	1.74	-0.02	-11.98	1054.24	156.34	144.36	13.7%
Texas GT	117	2.38	1.66	-0.72	-84.24	278.46	29.13	-55.11	-19.8%
Transco	204	2.51	1.69	-0.82	-167.28	512.04	51.71	-115.57	-22.6%
Transwest	82	2.17	1.55	-0.62	-50.84	177.94	19.07	-31.77	-17.9%
Trunkline	167	2.20	1.71	-0.49	-81.83	367.40	42.84	-38.99	-10.6%
United	33	2.57	1.66	-0.91	-30.03	84.81	8.22	-21.81	-25.7%
Williams	175	2.15	1.47	-0.68	-119.00	376.25	38.59	-80.41	-21.4%
TOTAL	3715				-1282.18 (-24.6%)	7390.33		-365.96	-5.0%

Table 1Aa provides a less conservative estimate of the GIC demand charge than does Table 1Ab. The tables differ in the assumptions made about the relationship between the figure in column (B) ("Volume") and the volume that would be used in computing the GIC demand charge (the "GIC basis," or customer entitlements, which may be interpreted as either nominations or CD). Table 1Aa assumes that volume is 75% of entitlements, on the theory that actual sales will be less than customer entitlements. Following the Notice of Proposed Policy Statement, pp. 12 - 16, the demand charge in column (I) is figured by multiplying column (B) times the allowed rate of return (assumed to be 15%) times the average spot price in Column E.

Table 1Ab below assumes that volume is 100% of entitlements, and therefore applies the 75% factor to Column B in finding the demand charge. The demand charge as figured as .75 times column (B) times the allowed rate of return (assumed to be 15%) times the average spot price in Column E. Therefore, column (I) of Table 1Ab is .75 times column (I) of table 1Aa.

Table 1Ab -- If "Volume" (Column B) is 100% of GIC Basis

(A)	(B)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
	1988 WELLHEAD PURCHASES			WELLHEAD AVG vs SPOT DIFFERENCE:			ADDING THE GIC DEMAND CHARGE		
Pipeline Name	Volume	Weighted Average Price	1988 Avg Spot Price	in Price (E-D)	in Revenue (F*B)	Revenue for Gas at Avg Wellhead (D*B)	Demand Charge (.15*.75 *E*B)	Revenue Differenc (G+I)	Percent Revenue Differenc (J/H)
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CIG	157	1.52	1.47	-0.05	-7.85	238.64	25.96	18.11	7.6%
Columbia	361	2.31	1.66	-0.65	-234.65	833.91	67.42	-167.23	-20.1%
CNG	82	2.84	1.74	-1.10	-90.20	232.88	16.05	-74.15	-31.8%
El Paso	201	1.76	1.58	-0.18	-36.18	353.76	35.73	-0.45	-0.1%
Fla GT	147	1.99	1.70	-0.29	-42.63	292.53	28.11	-14.52	-5.0%
KN	64	1.63	1.53	-0.10	-6.40	104.32	11.02	4.62	4.4%
Natural	132	2.05	1.64	-0.41	-54.12	270.60	24.35	-29.77	-11.0%
Northern	369	1.45	1.64	0.19	70.11	535.05	68.08	138.19	25.8%
Northwest	90	1.94	1.48	-0.46	-41.40	174.60	14.99	-26.42	-15.1%
Panhandle	69	2.29	1.60	-0.69	-47.61	158.01	12.42	-35.19	-22.3%
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Williams	175	2.15	1.47	-0.68	-119.00	376.25	28.94	-90.06	-23.9%
TOTAL	3715				-1282.18 (-24.6%)	7390.33		-595.01	-8.1%

Tables 1Aa and 1Ab show that the revenue reductions in column (G) of the original table (-24.6% average) are greatly overestimated. After adjusting for the demand charge estimates, the overall revenue reduction is diminished, declining by roughly two-thirds (conservatively) or four-fifths (less conservatively).

It should be noted that the estimates provided in Tables 1Aa and 1Ab are both conservative estimates, in the sense that any possible negative impact on gas suppliers will be further reduced because:

- Average wellhead prices and spot prices are converging, whether or not GICs are implemented. As EIA said (p. 8, caveat 4), the data in the tables do not take account of contract renegotiations that anticipated the Order 500 take-or-pay settlement date of March 31, 1989. As EIA stated, "The difference between wellhead and spot market prices may not be as large in the future."

- Lowering the volumetric rate for sales gas from WACOG to the spot price should make contract gas more attractive and therefore increase the amount of gas nominated under contract. Increased nominations will increase the GIC basis, and therefore will increase the GIC demand charge.

- Spot prices in Column (E) may be underestimated by the averaging process. As EIA mentioned (p. 8), figures in column (E) are simple yearly arithmetic averages of the monthly prices, and do not reflect the seasonality of spot prices. More gas is purchased in the winter, when spot prices are high, so an average spot price weighted by the associated volumes would be higher.

QUESTIONS FOR THE RECORD FROM SENATOR FORD

Question 1: The Commission is to be commended for going as far as quickly as it has in creating the regulatory environment for establishing a procompetitive interstate pipeline transportation structure. However, it seems critical that the Commission complete that task by prompt resolution of a workable regulatory framework for the pipeline sales function to operate in the "open access" competitive transportation environment.

Are there remaining legal or policy impediments to prompt action on pipeline settlements which provide a resolution of the pipelines' sales function with their customers if the directly affected sales customers have agreed with the settlement proposal?

Answer: There may be legal or policy considerations to consider when acting on pipeline sales rate settlements even where all of the pipeline's directly affected sales customers agree to the settlement proposal. Interstate pipeline sales rates generally affect interests beyond the sales customers that purchase directly from the pipeline. For example, pipelines sell to local distribution companies and to other pipelines that resell the gas to local distribution companies in various regions. As a result, the Commission must consider the interests and views of those beyond the immediate purchasers from a pipeline. Where a settlement is uncontested the Commission has the authority to, and generally does, promptly approve uncontested settlements as in the public interest. For example, at the Commission's September 27th meeting the Commission voted in principle to approve a settlement, filed June 29, 1989, by Columbia Gas Transmission Corporation, and supported by its sales customers, to restructure its sales functions.

However, there can be legal and policy impediments to prompt approval of a settlement. For example, if a settlement is contested, the Commission must resolve the contested issues on the merits, even if the immediate sales customers do not contest the settlement. This may delay Commission action on a settlement because a record sometimes must be developed to resolve the contested issues. In addition, the Commission's recently established policy with respect to pipeline rate settlements is that the settlement must be supported by a record that takes into consideration the Commission's rate design policies as announced in the Interstate Natural Gas Pipeline Rate Design, et al., 47 FERC ¶ 61,295, order on reh'g, 48 FERC ¶ 61,122 (1989). If a settlement, even an uncontested settlement, is filed without the appropriate documentary support, Commission consideration of the settlement may be delayed while the pipeline and other parties to the settlement develop the record necessary for the Commission to evaluate the settlement under its rate design policies.

Question 2: Has the Commission adopted an internal policy that would preclude interstate pipelines from being able to compete with others in the sales function on a comparable basis?

Answer: No. In Order No. 500 the Commission proposed that pipelines be permitted to establish future gas supply charges or gas inventory charges. GICs are intended to help pipelines restructure their service obligations to customers and their purchase obligations to producers to better reflect future operations and prevent a reoccurrence of the take-or-pay problem. The GIC is intended to be an efficient pricing structure for the pipeline merchant function which recognizes the increased supply options available to the pipeline's sales customers through open access transportation.

In the GIC proceedings, the Commission is also concerned that the pipeline not have an undue competitive advantage over other suppliers. In these proceedings the Commission has instructed the parties to examine whether changes are necessary in firm transportation and storage services to assure that the customers have reasonable alternatives to the pipeline's sales service under the GIC. However, this is not reflective of an "internal policy" of precluding pipelines from being able to compete. Rather, it reflects the Commission's general policy of encouraging competition to benefit the consumer.

Question 3: What are you going to do about the take-or-pay that accrues between March 31, 1989, the cutoff date for take-or-pay settlement recovery, and the time a company has its GIC approved by the Commission?

Answer: The Commission has taken several actions that will assist pipelines in dealing with take-or-pay that accrues between March 31, 1989, and the time a pipeline's GIC certificate becomes effective.

First, in Order No. 500, the Commission established a crediting mechanism specifically designed to minimize the accrual of take-or-pay liability. The crediting regulations condition open-access transportation of a producer's gas on the producer providing credits for the transported volumes against take-or-pay liability. To encourage the settlement of take-or-pay, the regulations provide that the crediting requirement may be waived by the mutual agreement of the producer and pipeline. The crediting rule was not affected by the March 31, 1989 deadline.

Second, 23 pipelines have on file tariffs with approved litigation exceptions pursuant to Order No. 500-F. This exception permits pipelines to recover take-or-pay costs related to contracts that were in litigation on March 31, 1989. Thus, pipelines may be able to recover certain post-March 31, 1989 take-or-pay related costs when the contracts are settled, or litigation or arbitration has run its course.

Finally, the Commission has encouraged pipelines to file and to accept gas inventory charges (GIC). The Commission views the GIC mechanism as a means to avoid a recurrence of the take-or-pay situation.

Question 4: The Commission presumably intends that the GIC become incorporated into the pipeline's service obligation. But because the pipeline's obligation to serve continues beyond the life of the contract, doesn't that continued obligation conflict with the concept of a GIC as presented in Order No. 500?

Would the Commission grant abandonment of a GIC to a pipeline that cannot negotiate a new contract with a customer?

Would it grant that abandonment if the customer opposed it?

Answer: The GIC is a certificated service and like any other certificated service would require approval under Section 7(b) of the NGA before service may be terminated. Commission action on an application to abandon service would depend on the facts of the individual case.

Based upon the renegotiation that is likely to occur in GIC proceedings, the pipeline's service obligation and a GIC are fully consistent. For instance, abandonment under the GIC certificate would only occur as a result of reduced nominations by the customer. Therefore, abandonment results from the customer's actions.

Question 5: Would basing a GIC on the natural gas spot market retard exploration and development through a back door reimposition of wellhead controls?

Answer: No. A spot-price based GIC does not and will not reimpose wellhead price controls. Wellhead price controls were based on original accounting costs. When the price of oil quadrupled, the value of natural gas soared, yet the accounting costs of existing gas did not change at all. Gas could be sold for market value on the intrastate markets, but only at accounting cost prices in interstate markets. The result was the severest shortage of interstate gas ever experienced. Under a market based GIC, prices respond to changes in market conditions (i.e., supply and demand), which then results in higher or lower prices.

It is this competitive market demand which will largely determine the appropriate amount of exploration and development.

Question 6: Have interstate pipelines generally exempted small general service customers from their proposed GICs?

Answer: A few pipeline applications have proposed to exempt small customers, but most have not. The response to question No. 7 provides a list of all GICs currently pending before the Commission, and the GIC filings approved by the Commission for Texas Eastern Transmission Corporation and Transwestern Pipeline Company. This list shows whether small customers are exempted.

Question 7: Do you know of any pipelines that have not exempted small general service customers from the proposed GIC?

Answer: Yes. Below is a list of all GICs currently pending before the Commission, and the GIC filings approved by the Commission for Texas Eastern Transmission Corporation and Transwestern Pipeline Company. The list specifies which GICs have proposed to exempt small general service customers.

Exemption of Small General Service Customers
Gas Inventory Charge (GIC) Proceedings On File

Pipeline	Docket	Exempted	Not Exempt
Columbia	RP86-168, et al.	X	
El Paso	CP88-203	X	
El Paso	CP88-434	X	
National Fuel	CP89-1582		X
Natural	CP89-1281		X
Northern	CP89-1227		X
Northwest	CP86-578		X
Northwest	CP89-1740		X
Southern	CP89-1721		X
Tennessee	CP89-470		X
Texas Gas	CP89-1119	X	
Texas Eastern	CP88-136	X	
Transco	CP88-391		X 1/
Transwestern	CP88-143	X	
Kentucky West	CP89-2092		X

1/ Not exempt, but special rules for small customers are proposed.

Question 8: Has The Commission considered exempting small general services customers from the GIC?

Answer: This issue has been raised in some of the GIC proceedings, and the Commission has permitted the parties to address this issue in their evidentiary presentations. The Commission will make a decision on this issue on a case by case basis in each of the proceedings.

QUESTIONS FOR THE RECORD FROM SENATOR NICKLES

Question 1: At its February 15, 1989 meeting, the Commission considered a draft order regarding Transco's gas inventory charge (GIC), which held the spot market price to be the just and reasonable amount pursuant to section 601 of the NGPA. At that time the draft order was made available by the Commission for public review. Accordingly, please provide the Subcommittee with a copy of that draft order.

Answer: A copy of the draft order is attached.

RP-1(B) DRAFT

FEB 15 1989

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

CERTIFICATES: GAS INVENTORY CHARGE

Before Commissioners:

Transcontinental Gas Pipe Line Corporation	)	Docket Nos. CP89-728-000; CP88-391-000; and RP88-167-000

ORDER ISSUING LIMITED TERM CERTIFICATE FOR INTERIM GAS INVENTORY CHARGE

On May 12, 1988, Transcontinental Gas Pipe Line Corporation (Transco) filed in Docket Nos. CP88-391-000 and RP88-167-000 an "Application for Certificate of Public Convenience and Necessity for Service Restructuring, For Abandonment Authorizations, and For Approval of Tariff Changes Pursuant to Stipulation and Agreement." 1/

Transco operates both as a merchant of gas under various sales rate schedules and as an open access transporter under Part 284 of the Commission's regulations. In its filing, Transco proposes to comprehensively restructure its sales, transportation, and storage services to bring its "system fully into the post-Order No. 436 era of open access and market-oriented services." 2/ Among other things, Transco proposes a gas inventory charge consisting of daily and monthly option service charges and a gas commodity charge which employs a price formula keyed to Gulf Coast spot market prices.

In a companion order issued this date, the Commission is setting Transco's gas inventory charge proposal for hearing. In the instant order, the Commission offers a limited term certificate to Transco which will permit Transco to implement an interim gas inventory charge upon its acceptance of the proffered certificate while the Commission considers a permanent gas inventory charge for Transco. The Commission is offering Transco a limited term certificate for a gas inventory charge for two reasons. First, most of the intervenors in Docket Nos. CP88-391-000 and RP88-167-000 either supported or did not oppose the implementation of a gas inventory charge. Second, the Commission believes that in the current economic and regulatory environments

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1/ Transco supplemented its filing on May 20, 1988.

2/ Transmittal Letter at 4.

for the natural gas industry, it is in the public interest for interstate gas pipelines such as Transco to implement gas inventory charge mechanisms as soon as possible in order to limit any gap between the recovery of past take-or-pay costs and future take-or-pay costs. This interim implementation of the gas inventory charge mechanism will benefit both pipeline and customer by enabling them to plan and coordinate their relationship and their relationships with others pursuant to current needs and within the framework of a rational, efficient pricing structure. As the Commission stated in Order No. 500:

> The new rate design is intended as a future-looking mechanism to recover the costs of contractually committing gas service that has been tailored to meet the customer's nominations whenever fewer than nominated volumes (or a reasonable percentage of nominated volumes) are taken by a customer, who is fully aware that such charges would be currently assessed on a monthly basis, based on its own service nomination. In brief, the Commission is seeking to establish a rational, efficient pricing structure for the pipeline merchant function with emphasis on reciprocity and consideration of service obligations under the increased options available to a pipeline's sales customers. 3/

The Commission invites other pipelines to file for a similar limited term certificate for an interim gas inventory charge along the lines of the instant certificate.

I. The Relationship of the Dockets

Transco filed its Application in Docket Nos. CP88-391-000 and RP88-167-000. The Commission is offering this limited term certificate to Transco in Docket No. CP89-728-000. Intervenors in Docket Nos. CP88-391-000 and RP88-167-000 are being made intervenors in Docket No. CP89-728-000. The dockets are not consolidated. Hence, all petitions for rehearing or other requests with respect to the instant certificate should be filed only in Docket No. CP89-728-000. In addition, the Commission is issuing Transco a certificate for interruptible sales service in Docket No. CP89-759-000 and will be considering its proposal for a certificate for open access storage in another docket.

3/ FERC Stats. and Regs. ¶ 30,761 at p. 30,794 (1988).

II. Transco's Proposal

Transco's proposal consists of a daily and a monthly option service charge and a gas commodity charge which employs a price formula keyed to Gulf Coast spot market prices. 4/ Transco's option service charges are derived by multiplying various premia determining percentages times the gas commodity charge. Transco submitted in Appendix B2 to its application an examination of the future "costs of providing secure, long-term gas supply" for purposes of determining the premia used in developing its option service charges.

In the companion order, the Commission is setting Transco's proposed gas inventory charge for hearing where Transco must demonstrate that its markets are subject to sufficient competition to make its rates just and reasonable or, if they are not, that its proposed premia and spot price formula are in the public interest. In the interim, the Commission has concluded that Transco's basic concepts -- namely, the use of spot market prices as the basis for the gas commodity charge and a premium times that price (percentages) as the option service charge -- are in the public interest. Accordingly, the Commission is offering Transco a limited term certificate for a gas inventory charge which consists of a gas commodity charge based on the spot market price composite as derived pursuant to Appendix A to this order 5/ and a gas inventory (option service) charge derived as discussed below.

For the reasons stated below, the Commission finds that this certificate is required by the public convenience and necessity.

4/ Transco's proposal is described in greater detail in the companion order in Docket No. CP89-391-000, *et al*.

5/ Part VI sets out the adopted spot price composite calculations. In brief, the price will be a composite price made up of the average of spot prices reported by four independently published periodicals for those geographic areas closest to Transco's sources of gas supply. The composite price for a given month will be the average of the preceding month and will be the maximum price that Transco may reflect for the gas components of its rates. Transco may reflect a lower price in the gas component of its commodity rates. But the option charge could still be based on the spot price index.

III. The Spot Price Concept

The Commission believes that a composite price based on spot market prices can serve as an appropriate basis for sales service (the gas commodity charge) and for the gas inventory charge if the following four conditions are satisfied: (1) that the spot market functions properly, in the sense that price responds to changes in the demand and supply of gas, (2) that the spot price average used by the pipeline is representative of actual spot prices in supply areas from which the pipeline receives its gas, (3) that such spot price reports be readily available (by subscription or otherwise) to the pipeline, its customers and to the Commission, and (4) that such reports should be published at least monthly by an entity not engaged in the business of buying, selling, transporting or brokering natural gas.

The Commission has examined the available data on the spot market (see Appendix A to this order) and concludes that it is a well functioning market in the sense that it is broad (spot sales as a percent of total throughput are variously estimated at between 35 and 70 percent), and that it responds to forces of supply and demand (i.e., there is a pronounced seasonal effect on spot prices).

The Commission has also examined the behavior of spot price series published in four different trade periodicals and concludes that the series are in general agreement with one another, and that the spot prices respond to the forces of supply and demand. Thus, the Commission believes that spot prices can serve as an appropriate basis for sales service and the gas inventory charge and that spot prices published in the four trade periodicals examined are representative of spot prices in the supply areas to which they refer.

The Commission concludes that spot market prices may serve as the basis of gas commodity and gas inventory charges because such prices are representative of market prices and are therefore just and reasonable and in the public interest. 6/ In addition, the use of spot prices is in accord with the intent of Congress in enacting the Natural Gas Policy Act that market prices play a "more significant role in determining the supply, the demand, and the price of natural gas." 7/

6/ FPC v. Sunray Dx Oil Co., 391 U.S. 15, 25 (1967) ("[T]he 'true' market price [is] the just and reasonable rate")

7/ Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Miss., 106 S. Ct. 709, 717 (1986).

IV. The Gas Inventory Charge Premium

A. Theory

The Commission believes that a gas inventory charge may be developed from the perspective of the value of gas supply contracts to the pipeline and its customers. The focus is on the aggregated value of the pipeline's inventory of contracts.

From the pipeline's perspective, entering into gas supply contracts with producers is a necessary step in the process of offering firm merchant sales service to its customers. Without those contracts the pipeline could not provide reliable firm sales service. The benefits associated with those contracts are not realized, however, without some obligations and financial risk to the pipeline. For example, gas supply contracts can be viewed (at least in an operational sense) as providing something of intrinsic value to the pipeline and customers demanding merchant service by the pipeline. But the pipeline may, nonetheless, be exposed to financial risks contained in the contracts. If the pipeline does not perform in accordance with the contracts, the pipeline may be exposed to the incurrence of added costs (e.g., take-or-pay liability claims, contract reformation costs, etc.).

For the purposes of quantifying a gas inventory charge, an analogy can be drawn between compensation for the "exposed value" of net depreciated fixed assets and compensation for the pipeline's exposure under its inventory of gas supply contracts. This approach derives the gas inventory charge based on the value of the pipeline holding an inventory of gas supply contracts for the benefits of its customers, not on the pipeline customers' "deficiency quantities." In other words, this approach derives the gas inventory charge by balancing the gas supply insurance for the pipeline's customers for the pipeline's inventory of gas supply contracts and the costs to the pipeline of holding and managing that inventory of contracts.

The approximate value of an inventory of gas supply contracts can be established for these purposes based on the expected value for which the pipeline could sell the gas in the competitive market. Although that price would be expected to vary over time, the adoption of the monthly average spot prices in Transco's major gas supply areas is reasonable. (See Footnote 5 and Appendix A.)

Periodic changes in the spot price index reflect market changes in natural gas supply and demand and incorporate the effects of inflation. This approach establishes the gas inventory charge based on an "instantaneous charge." By using a "variable" price index there is no need for any discounting (in a "present value" context) or for factoring in inflation of future expected prices for the purposes here.

Also, the instantaneous charge does not require any discounting (in a "present value" context) of the quantity of gas to be produced at future dates under individual or aggregated contracts. Rather, this approach assumes that the pipeline will maintain an inventory of gas supply contracts consistent with the service demands of its customers. That is, the pipeline would be expected to add new contracts where they are needed and shed other contracts when appropriate.

The net effect is that the pipeline would be expected to maintain an inventory of contracts, providing the aggregate instantaneous deliverability, long-term reserves, and contract provisions consistent with the merchant service demands of its customers. The mix of physical features (e.g., deliverability, rate of production decline, expected depletion period, etc.) related to the gas supply supporting individual contracts, and the contract parameters (e.g., price, take requirement, make-up provision, etc.) would be expected to satisfy these requirements. Thus, there is no need to examine the operation of individual contracts.

2. Quantification

The essential question is how to best recognize through the pipeline's current rates the value to the pipeline's customers for risks undertaken by the pipeline in assembling an inventory of gas supply contracts, whether short or long-term, needed to fulfill its merchant function.

In the past, the pipeline has been compensated for its take-or-pay costs by including gas prepayments in the pipeline's rate base and imputing the pipeline's overall pre-tax rate of return allowance to such costs. However, the pipeline forgoes this rate treatment (and any other means of collecting take-or-pay costs) when it elects the gas inventory charge. Thus the risks attending the inventory of contracts held by the pipeline are shifted entirely to the pipeline.

The Commission believes it is reasonable to compensate the pipeline for costs reasonably associated with the risk of holding gas supply contracts at the same level that the Commission compensates the pipeline for holding its physical assets. That is, assuming the approved pre-tax return utilizes the current 34% Federal tax rate, we see no reason to adjust the pipeline's approved cost of capital allowance for use in developing the interim gas inventory charge. For Transco, the cost, based upon its current effective pre-tax rate of return, is 15.39 percent. 8/

The next step in quantifying the interim gas inventory charge developed here requires an estimation of a reasonable overall take-or-pay level to assign to the pipeline's inventory of contracts. On December 16, 1982, the Commission adopted section 2.103 of the Commission's regulations which established 75 percent of deliverability as the take level above which no presumption of prudence would attend for new contracts. 9/ Prior to this time, new gas supply contracts typically incorporated considerably higher take levels (*e.g.*, 90 percent was not uncommon). In prescribing the 75 percent take-or-pay factor, however, the Commission made clear that 75 percent was the upper limit, and that it was not intended to be a floor. Nothing stated here should in any way be construed as suggesting that the 75 percent factor is anything other than an upper limit for use in the gas inventory charge formula described here.

Thus, it would not be appropriate to develop the interim gas inventory charge simply by multiplying the pipeline's pre-tax rate of return by the price of the gas. That is because the pipeline is not at risk for the full quantity of gas available under its inventory of gas supply contracts. It is only at risk for the quantity of gas subject to the take-or-pay requirement. And, as explained above, there is a ready reference point that recognizes that the pipeline is not at risk (or certainly it should not be) for the full quantity of gas supporting the

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8/ The 15.39 percent pre-tax rate of return is based upon the following data from Transco's Docket No. RP87-7 which underlies a cost of service settlement that has been approved by the Commission.

	Capital Structure	Capital Cost	Weighted Capital Cost	Pre-Tax Cost (w/ 37.4% Composite Tax Rate)
Debt	49.81%	10.16%	5.06%	5.06%
Preferred	19.04	9.47	1.80	2.87
Equity	31.15	.00	4.67	7.46
Total	100.00%		11.53%	15.39%

9/ The Commission has referred to this policy in addressing take-or-pay issues in its orders. See, *e.g.* *State of Michigan and Michigan Public Service Commission v. Trunkline Gas Co.*, 24 FERC ¶ 61,013 at 61,,060 (1983) and *Tennessee Gas Pipeline Co.*, 26 FERC ¶ 61,102 at 61,247-48 (1984).

contracts. That factor is the 75 percent deliverability factor that appears at section 2.103 of the Commission's regulations.

The Commission therefore adopts the 75 percent factor as a reasonable generic approximation to compensate for the exposure that the pipeline would have under the operation of take-or-pay provisions in its contracts. 10/ This level of inferred take requirement should result in adequate compensation for the risks of exposure to take-or-pay and contract reformation costs undertaken by the pipeline. At the same time, the "reconciliation mechanism" -- which is described below -- will provide adequate protection to the pipeline's customers.

In summary, the approach developed here recognizes and accounts for several features. First, it recognizes that the gas supply available to the pipeline and its customers through the pipeline's inventory of gas supply contracts provides something of value to the pipeline and its customers, *i.e.*, gas supply insurance. This inventory of contracts takes on similarities to and provides the equivalent operational functions (in an operating sense, but not in a financial accounting sense) as though the pipeline itself owned the gas supply supporting the contracts. This feature is recognized for ratemaking purposes by imputing an economic value based upon the pipeline's overall pre-tax rate of return and the price at which the gas would be available from time to time to the pipeline's customers.

Second, the approach recognizes that the pipeline is not at risk for all of the gas supply supporting the inventory of contracts held by the pipeline, but only to the extent of its take-or-pay and other contract requirements. This feature is recognized for ratemaking purposes by, effectively, viewing the pipeline's inventory of contracts as one "umbrella contract" and imputing the generic 75 percent take factor discussed above. The use of this factor also serves as an acknowledgement of the Commission's general policy against take obligations above the 75 percent threshold, thereby encouraging continued contract renegotiations of contracts that have not yet been reformed to reflect the realities of the natural gas market.

10/ We recognize that Transco, like most other pipelines, has extensively renegotiated its gas supply contracts to incorporate lower take-or-pay levels and more favorable pricing provisions. For example, information in Transco's Docket No. RP87-7 proceedings apparently indicates that Transco's average take-or-pay requirements were about 85 percent of gas under contract during the 1980-85 period and about 74 percent during 1986.

Under the approach outlined here, the overall level of Transco's gas inventory charge would be established by the product of the following three factors:

(1) The monthly average price of spot purchases, estimated for illustrative proposes here to be about $2.00/MMBtu;

(2) Transco's overall pre-tax rate of return, currently 15.39 percent; and

(3) An inferred overall take requirement of 75 percent under Transco's inventory gas supply contracts.

Those factors in this illustrative computation support a gas inventory charge level of : $2.00/MMBtu x 11.54 % = 23¢/MMBtu. A customer's monthly entitlement times 23¢ equals its total monthly option charge obligation.

The option service and gas commodity charges together are intended to cover Transco's total payments to producers such as the cost of gas Transco purchases (including any premia paid for long-term contracts), option charges to producers, prepayments, and contract reformation costs.

3. Reconciliation Mechanism

As noted above, the interim gas inventory charge has been based on factors that are known at the time of its authorization (e.g., pre-tax rate of return, imputed take requirement) and the spot price of gas -- which, although not known now, will be based on future events (i.e., changes in spot prices) and will be known as those future events occur. What the Commission does not know, and is unable to project at this time, is the pipeline's actual level of gas options payments, take-or-pay payments, contract reformation costs, and other costs related to its merchant function. That is, because we are dealing with a new service, there are no "base period" data upon which projections of these future merchant-function costs could be made. To address this concern and to guard against excessive charges to the pipeline's customers, a "reconciliation mechanism" is adopted.

The reconciliation mechanism is straight forward. It compares at the sum totals of actual revenues and actual expenses for the following:

(1) Transco's revenue collection through (a) its charges for the gas actually sold by it as a merchant (here set at the spot prices as a maximum), and (b) its gas inventory charge (here set at 11.54 percent of the spot price index); and

(2) Transco' actual payments for (a) the gas it purchased and resold as a merchant, and (b) carrying charges on gas options payments, prepayments, take-or-pay buy-out/buy-down settlement payments, and contract reformation costs (less any amounts recovered under the litigation exception of its Order No. 500 passthrough mechanism).

Within ninety days following the end of the limited term certificate authorizing the instant gas inventory charge, Transco must file a reconciliation report with the Commission. To the extent that the report includes material that Transco believes is confidential and proprietary (e.g., take-or-pay settlement payments, etc.), Transco will be free to seek confidential treatment of any such material consistent with the Commission's regulations. Customers and other affected parties will be entitled to comment on Transco's report.

To conclude, the "reconciliation mechanism" for the interim gas inventory charge should be based on the difference between Transco's total collection of revenues and total expenses attributable to its merchant function during the period that the gas inventory charge was in effect. Any excess revenues must be refunded to Transco's customers in proportion to their monthly nominations during the period that the interim gas inventory charge was in effect. Interest on any over collections should be imputed from the end of the period that the interim gas inventory charge is in effect at the rate of interest for refunds specified in the Commission's regulations. Transco would be at risk for any under collections of revenue, and Transco would not be permitted to file to recover the costs of any under collections. We believe these procedures strike an appropriate balance between the needs of Transco for funding its merchant function and protection against any excessive charges to Transco's customers during the period that the interim gas inventory charge is in effect.

V. Related Requirements

The Commission believes it in the public interest to condition the instant certificate to ensure that the gas inventory charge is not anticompetitive or unduly discriminatory. These conditions are as follows:

(1) The certificate shall be for a period of two years from the date of Transco's acceptance of this certificate. This will provide adequate time for hearing and decision on and implementation of Transco's gas inventory charge proposal in Docket No. CP88-391-000. In addition, this will provide sufficient time for Transco to implement the interim gas inventory charge

and will provide maximum certainty to Transco and its customers.

(2) Transco must use its existing firm sales rate schedules for implementation of the interim gas inventory charge. 11/ Transco must use the gas inventory charge mechanism for service under all its firm sales rate schedules. 12/ This will enable Transco's customers to continue service under existing rate schedules during the period of the interim gas inventory charge and avoid disruption in service at the conclusion of the two-year period if Transco's proposed gas inventory charge has not gone into effect.

(3) Transco must implement a 100 percent standby service under all its firm sales rate schedules whereby its firm sales customers may take their full daily entitlements as either sales, transportation, or any combination of sales and transportation. Transco's standby charge must be separately stated in each firm sales rate schedule and must be designed as set forth in the companion order setting its application for hearing. 13/ Transco's transportation under standby service shall be performed under its firm transportation rate schedule (Rate Schedule FT). This condition ensures that customers will make their gas purchase decisions based solely on the price of gas.

(4) Transco must permit its firm sales customers to freely nominate both monthly and annual requirements, provided that a customer's total of monthly entitlements cannot exceed its nominated annual entitlement. Any customer which nominates monthly and annual entitlements below its full current contract demand level during the

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11/ Transco will need to modify its existing rate schedules to reflect the option service and gas commodity charges. Moreover, Transco should revise its tariff to include the instant methodology for calculating the option service and gas commodity charges.

12/ Rate Schedules G and OG may have one-part rates which include the effect of an imputed gas inventory charge based upon the imputed load factor for those schedules.

13/ See Part IV. B.1. of the companion order. The Commission repeats that if a shipper pays for gathering as part of the cost of Transco standing ready to sell gas, the shipper should not also pay for gathering as part of its transportation charges.

period of this gas inventory charge shall be considered to have consented to abandonment of the amount not nominated. However, subject to the above, a customer can on any given day take its full daily entitlement. 14/

(5) Transco must permit its firm sales customers to convert up to 100 percent of firm entitlements to firm transportation service. Such conversions shall be permanent and not solely for the term of this interim certificate. Provisions (4) and (5) will enable Transco to tailor its gas supply to meet customer nominations without guessing what supply may be needed or shed in the future.

(6) Transco must terminate the operation of its purchased gas adjustment (PGA) clause for the term of this interim certificate and shall be entitled to direct bill its Account No. 191 balance, including transition costs subject to the conditions set forth in the companion order. 15/ This will more closely match cost responsibility with cost incurrence and remove future uncertainty for Transco and its customers as to the disposition of the monies in that account. Transco may only reinstate its PGA by complying with section 154.303(b) of the regulations or by establishing its right to a waiver therefrom.

(7) Transco will be subject to the reconciliation mechanism discussed above. Transco must provide a reconciliation study as set forth above within 90-days of the end of this limited term certificate and refund any overcollections.

(8) Transco must remain an open access transportator under Part 284, Subpart G of the Commission's regulations for the term of this certificate.

14/ See 18 C.F.R. § 2.105 (1988). Transco may not impose a nomination threshold if it accepts this certificate. See Part IV, B.2. of the companion hearing order.

15/ See Part IV, H. 5. of the companion hearing order. In summary, Transco must permit its customers to pay the direct bill either in installments or in a lump sum; Transco's customer may challenge the prudence or reasonableness of the direct billing amounts; and Transco must make any applicable refunds to its customers.

(9) Transco must remove its restrictions on its customer's ability to inject gas purchased from others into contract storage and permit flexible receipt points in its Rate Schedule FT contracts. 16/

(10) Transco is also subject to the conditions discussed in the companion hearing order. It must

(a) continue to use its current authorized overrun and scheduling penalties (Part IV. G.1. and 2.)

(b) retain its present requirement for information concerning affiliates in requests for transportation service. (Part IV.G.3.)

(c) allocate priority to interruptible transportation customers as discussed in Part IV.G.7

(d) file revised tariff sheets with respect to gas supply curtailments (Part IV. H.4.).

(e) comply with the exculpatory language discussion of Part IV.B.5.

(f) comply with the fuel requirements discussion of Part IV.B.15.

(g) comply with the producer settlement cost and take-or-pay (including, without limitation, cross-crediting) discussion of Part IV.H.3.

In addition, Transco's acceptance of this certificate shall constitute a waiver by it of its right to seek judicial review of each and every aspect of this order. The Commission believes that this is appropriate because Transco's acceptance of this certificate is voluntary. It may reject the certificate and retain its current sales service pricing procedures and pursue its gas inventory charge proposal in the hearing set by the companion hearing order. It would be unfair if it could accept the certificate which is a package and litigate its individual parts.

The Commission will also require Transco to make a full Section 4 rate filing under Section 154.63 of the regulations within 90 days of its acceptance of the certificate because

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16/ Transco permits its firm transportation customers to add or delete receipt points on 30 days written notice.

Transco does not have a current rate case pending 17/ or rates which were established based on a base period ending within 12 months from the date this certificate would go in effect. hence, such items as Transco's rate of return on equity and throughput may be out of date and its allocation of costs and levels of service may not be in sync.

At a hearing held on February 15, 1989, there was received and made a part of the record in this proceeding all evidence, including the Application and exhibits thereto submitted in support of the authorization herein.

The Commission will also require Transco to pay a filing fee for this certificate as its previous filing fee covered only the certificate application filed in Docket No. CP88-391-000. 18/

The Commission orders:

(A) Upon Transco's unconditional acceptance and the payment of a filing fee, a limited term certificate of public convenience and necessity is issued to Transco in Docket No. CP89-728-000 authorizing Transco to institute a Gas Inventory Charge for two years as described in the body of this order.

(B) The certificate issued in Ordering Paragraph (A) above is subject to the terms, conditions, and requirements set forth in the body of this order and the ordering paragraphs below.

(C) The intervenors in Docket Nos. CP88-391-000 and RP88-167-000 are intervenors in Docket No. CP89-728-000.

(D) Section 157.20(a) of the regulations shall not apply and Transco shall notify the Commission of its acceptance of this limited term certificate within 30 days from the date of this order. If, however, applications for rehearing are pending at the close of the 30 day period, the above-mentioned acceptance shall be made 30 days after the date the applications are resolved by the Commission.

(E) Transco must permit its customers to nominate both

17/ In Docket No. RP87-7 the Commission has approved a settlement that resolves the cost of service, overall throughput level, and many rate design issues. Certain specific issues were reserved by the settlement.

18/ Because RP88-167-000 has been terminated (see Part III of the companion hearing order), Transco may credit the filing fee therefor against the instant filing fee.

sales and transportation levels within 45 days after it accepts the instant certificate.

(F) Transco should file pre forma revised sales rates and tariff sheets to reflect the other revisions to the terms and conditions of its tariff concurrently with its acceptance of this certificate. Those rates and revisions may become effective no earlier than the first day of the month following the period for customer nominations. Transco's filing shall be under Section 4 of the Natural Gas Act and Part 154 of the Commission's regulations.

(G) Transco's rates filed pursuant to this order shall be subject to the final orders in Docket RP87-7-000 and Transco's compliance with the Commission's Opinion Nos. 260, 260-A, and related orders.

(H) Transco must make a full Section 4 rate filing under Section 154.63 of the regulations within 90 days of acceptance of the certificate.

(I) Transco will be at risk for any undercollections of non-gas costs during the period between the effectiveness of its revised sales rates authorized by this order and the effective date of the new sales rates filed pursuant to Ordering Paragraph (H) above.

(J) Transco must file with the Commission, on a monthly basis, tariff sheets reflecting the spot price utilized for purposes of computing the commodity sales rates and the options service charge.

(K) Transco's acceptance of this certificate shall constitute a waiver of its right to seek judicial review of each and every aspect of this order.

(L) Transco may recover its Unrecovered Purchased Gas Costs in Account No. 191 by direct billing as set forth in the text above.

(M) Transco may only reinstate its PGA by complying with section 154.303(b) of the regulations or by establishing its right to a waiver therefrom.

By the Commission.

Secretary

APPENDIX A

Question 2: Many producers are concerned that the Commission's proposed spot market GIC (the so-called "competitive price concept") will put a great deal of pressure on pipelines to reduce the amount they pay producers for natural gas, or even to abrogate wellhead purchase contracts altogether -- particularly if the spot market GIC is deemed or held by the Commission to be the just and reasonable amount. Do you share any of these concerns? What would be the consequences to domestic production and producers, particularly independents, if that were to occur?

Answer: The spot market price, whether below the interstate pipelines' purchased gas price or above it, will likely affect wellhead prices, particularly if a producer's wellhead prices are too far out of line with the spot market price. A producer-pipeline contract that totally ignores a substantially lower spot market gas price will be pressured by customers and the customers' markets -- not by a spot market based GIC -- to adjust the price. If contract prices are too high, they will either have to be renegotiated or the gas will not be marketable. Conversely, if contract prices are much lower than the spot price of gas, the demand for gas will be so great that the producer will be able to raise the contract price, thus bringing supply and demand into better balance. This can be expected to occur, and is actually occurring, regardless of whether any company should adopt the competitive GIC concept introduced in the Commission's Interim GIC proposal. The spot market price was included in renegotiated long-term contracts long before May 1989. These new contracts provided for the spot market price to be used as a basis for determining the appropriate rate for such gas, when price redetermination came due. To the spot price was to be added a certain premium for supply security.

The willingness of a producer to develop and produce natural gas will be based on an evaluation of market demand for gas at different prices. The demand for spot market supplies at the spot market price is one indication of short-term gas demand at a particular price and under particular contract terms.

Question No. 3: Do you believe that the Commission has the authority to deny the passthrough of amounts actually paid to producers for deregulated natural gas under the NGPA section 601 just and reasonable standard (but for fraud, abuse or similar grounds) in light of the explicit and unambiguous meaning of that provision?

Answer: No. I do not believe the Commission has the authority under the NGPA to deny the passthrough of amounts actually paid to producers for deregulated gas unless the Commission finds fraud, abuse or similar grounds. However, a pipeline may voluntarily elect not to flowthrough in toto the amounts that it pays to producers for deregulated gas under the NGPA if necessary to maintain sales.

Question No. 4: The "inventory charge" element of both proposed GIC alternatives does not appear to bear any relationship to the cost of maintaining supply. Is there any thing in the NOPPS which requires a pipeline to use the GIC supply security premium to maintain an inventory of gas? Is there anything in the NOPPS which requires a pipeline to ensure that an appropriate share of such amounts flow to smaller producers who have relatively less market power than major producers?

Answer: Yes. GIC supply premiums collected by the pipeline are to cover a pipeline's costs to maintain an inventory of gas, without regard to a producer's size.

Question 5(a): One of the fundamental defects of the proposed spot-market GIC is that it ties the price of pipeline gas sales to an artificial index. That index now is below most pipelines' WACOG, because of the softness in the gas market.

(a) If the market tightens, wouldn't the Commission's spot market GIC then result in above-market and above WACOG prices set for the GIC? What would happen then? What are the implications for consumers?

Answer: There is nothing artificial about spot market prices. They are real prices at which transactions in gas markets take place under certain contract terms. These prices fluctuate in response to market changes to maintain a balance between supply and demand. Nor is there anything artificial about an index of spot prices.

If the spot market tightens, spot prices will rise. The higher spot price is the market price, and it may well rise above a pipeline's WACOG. The true-up provision of the IGIC proposal prevents over-recovery of gas costs in this case.

Question 5(b): If the GIC is below WACOG wouldn't pipelines get "stuck" with the difference between that which they paid for gas and that which they sold it for? What are the implication of that for pipelines and producers?

Answer: If the GIC is below WACOG that means that spot prices are also below WACOG, and pipeline sales will be lost to the spot market if the pipeline tries to collect its WACOG. If the pipeline wants to sell gas in this situation, it may have to sell gas at a variable price that is less than that it pays producers. The demand component of the GIC allows the pipeline to recover additional revenue. For example, a demand-based GIC might permit a pipeline to recover a premium as much as 15% above spot prices. However, this additional revenue would not be enough to cover a difference more than 15%. This prospect will put pressure on pipelines to assure that their WACOG's do not get this far out of line with the market.

Also, to the extent that there are periods when spot prices are greater than the WACOG, they may offset periods when spot prices are less than the WACOG.

Question 5(c): What would be the basis for the Commission's defense that the methodology for calculating the spot market GIC is not arbitrary or capricious?

Answer: A competitive market price for the commodity charge and a premium above the market price for the demand or supply charge will provide the pipeline with sufficient revenue to cover its costs under long-term supply contracts if the customers request such such service.

Question No. 6(a): The Commission's NOPPS outlines two alternative formulations for GICs.

(a) Have the commentors on the NOPPS proposed any alternative formulations for a GIC?

Answer: Several commentors have proposed alternative GIC formulations. For example, a few commentors propose a demand based GIC coupled with a pipeline's PGA as the commodity charge rather than a competitive market price composite. Under another proposal, the commodity charge would be the competitive price and the interim GIC charge would be the pipeline's estimated WACOG minus the competitive price. This method could be used for both demand and deficiency type GICs. Another commentor, representing producers, proposed that producers charge a monthly reservation charge in addition to a commodity price for gas taken. The amounts of the charge and prices would be subject to negotiation among customers, pipelines and producers.

Question No. 6(b): With respect to the proposed "competitive price concept," is it necessary to tie the GIC to a spot market index?

Answer: In order to rely on market prices, the prices must be observable in order for the customer to make meaningful nominations and in order for the Commission to fulfill its responsibility to determine that the charges are in the public interest. This means, among other things, that they must be published in some easily obtainable form. At present, the only available price indices are for spot market prices. If a published index develops for long-term contract prices, it would be appropriate to use such an index in determining GIC charges.

Question 7: Under the NOPPS reconciliation mechanism, a pipeline need not refund over-collections to its customers; it can instead use those monies for: 1) premiums to producers; 2) take or pay buy-out/buy-down settlement payments; 3) contract reformation costs; and 4) carrying charges on gas prepayments. (NOPPS; p. 21)

The NOPPS is silent on the question of when, by what means, and for what reasons can parties challenge the uses of GIC overcollections. What are your views?

Answer: The interim GIC is to be used to recover the total cost of maintaining longer term gas supply commitments. This may include, for example, a premium paid to a producer to recognize the value of long term supply commitment or flexibility of takes or purchase requirements that may be included in the contract. These types of costs may be legitimately recovered through the interim GIC mechanism and are not overcollections. Overcollections must be refunded under the interim GIC mechanism.

In the NOPPS, the Commission stated that the pipeline would be required to file a report within 90 days following the term of the interim gas supply charge. The Commission envisioned that this report would be publicly noticed and that parties would be given an opportunity to comment on the report. Based on these comments and its own review of the report, the Commission would assess if any further proceedings were necessary to verify the amounts claimed or to challenge the appropriateness of the amounts claimed.

Question 8: In the NOPPS the Commission indicates that pipelines seeking to utilize interim GICs must offer their customers firm transportation service to the extent they nominate less than their firm sales entitlements. The NOPPS explained that, in this manner, pipeline customers would not be totally captive to the pipeline's sales service and that this fact of competition should impose discipline on the pipeline with respect to its gas purchasing practices.

Is it the case that an effectively functioning GIC requires a pipeline's customers to have the option to convert their sales entitlements to firm transportation and thereby have access to alternative supply options?

Answer: Yes. The NOPPS would give the customer the option to choose firm transportation service where the customer nominates less firm sales service than its entitlement, thus giving the customer access to diverse sources of supply.

Question 9: The Commission has been apprised by many diverse elements of the natural gas industry of the problems created by the present policy of attaching pregranted abandonment to firm transportation service that is created by a pipeline customer's conversion of this firm sales entitlement. As the Natural Gas Supply Association - the producer association whose members account for 90% of the natural gas produced in the United States - commented recently, the new competitive market environment that you envision for the natural gas industry cannot arise as long as there remains such a dramatic difference in the reliability of CD sales and firm transportation that the pipeline's LDC customers are not able to convert and, thereby, risk the possibility that their firm transportation capacity might be lost.

Given the importance of meaningful CD conversion rights to the establishment of just and reasonable GIC mechanisms, is it possible to establish any GIC - either interim or permanent - without resolving the pregranted abandonment issue first?

Answer: The issue may either be dealt with through negotiation or in the GIC proceedings. As the Commission noted in addressing this concern in the order granting Transcontinental Gas Pipe Line Corporation a blanket transportation certificate, the terms and conditions of converted service are freely negotiated. This should provide a customer converting its CD to firm transportation service the ability to negotiate any amount of contract stability, including the term of the contract, that it desires. In a recent settlement approved by the Commission involving Natural Gas Pipeline Company of America, Natural included an evergreen provision in its firm transportation rate schedule, which allows a shipper whose contract term is greater than one year an automatic extension of service by giving Natural six months notice prior to expiration of the primary term of the contract. In a recent settlement approved by the Commission involving Transcontinental Gas Pipe Line Corporation, the pipeline agreed to waive the right to file for abandonment of firm transportation, resulting from the conversion of a sales customer's sales entitlements. In Texas Eastern Transmission Corporation's transportation assignment program, the parties agreed to allow negotiation for a waiver of pregranted abandonment authority for the individual assignment transactions. These cases demonstrate that there are various ways the parties can address this issue. In the GIC proceedings themselves, this is an issue that is being addressed by the parties. The Commission can fashion similar conditions in the GIC proceedings if necessary to ensure comparability of sales and transportation services.

QUESTIONS FOR THE RECORD FROM SENATOR DOMENICI

Question 1(a): It appears that the proposed spot market gas inventory charge (GIC) adversely affects both producers and consumers.

(a) Would you agree that the spot market GIC ("competitive price concept") -- even if the Commission does not deem it to be just and reasonable -- would put a great deal of pressure on pipelines to push wellhead prices down towards the spot price?

Answer: There is no basis for the claim that a competitively-priced GIC would adversely affect producers or consumers. Both should be made better off by an efficiently functioning gas market where prices reflect supply and demand. Wellhead prices are determined by the supply and demand for natural gas, and not by the spot market price. The spot market price balances the short-run supply and demand.

Question 1(b): If the spot market GIC is deemed to be just and reasonable, would you agree that that would virtually guarantee that wellhead prices would fall to the spot price?

Answer: No. As stated previously, there is no predictable relationship between wellhead prices and spot prices. As is the case today, the market for 30-day delivery determines the spot price. Longer term delivery contracts will be affected by the spot price, but there is no reason to believe that they will be identical. Generally, long term prices are greater than short term prices.

Question 1(c): If the spot market GIC results in reduced exploration, would you agree that consumers would be adversely affected over the long run by reduced supply and increased prices, even though they may benefit somewhat from lower prices in the short run?

Answer: No. If the demand for natural gas does not warrant increased exploration, then consumers are better off if resources are diverted to other activities valued more highly. If at a later time the demand for natural gas increases relative to supply, then prices should also increase and bring about an expansion in exploration. Thus, in a well-functioning competitive market, changes in prices should guide the decisions of producers--not regulation.

Question 1(d): Would you agree that it would be possible to design a GIC which instead simultaneously benefits consumers and all segments of the natural gas industry?

Answer: The competitively-price GIC does simultaneously benefit consumers and all segments of the natural gas industry. It may not be the only type of GIC that will do this, which is why the Commission is encouraging interested parties to participate in designing permanent GIC's, on a pipeline-by-pipeline basis.

Question 2: During the 1960s and 1970s the Commission kept the wellhead price of natural gas artificially low, and that led to shortages in the interstate marketplace. Those growing gas shortages -- culminating with the severe shortage during the winter of 1976-77 which closed schools and businesses in the Midwest -- led to the enactment of the Natural Gas Policy Act of 1978.

The NGPA recognized and did away with the problems of having a dual market and interfering with wellhead prices, although for political reasons not all natural gas was to be deregulated pursuant to it. Congress only recently finished the job begun by the NGPA, and has now set a timetable for total wellhead decontrol.

It would appear, however, that the Commission is proposing to turn back the clock by artificially suppressing the wellhead price of natural gas in interstate commerce, albeit through a new regulatory mechanism -- the spot market GIC.

Do you think that the consequences of artificially interfering in wellhead pricing -- assuming that such action is lawful -- would result in any better outcome now than it did in the 1960s and 1970s?

Answer: Consistent with the direction of the NGPA, the Commission relies on market forces to determine the price for natural gas. It does not seek to artificially interfere with wellhead prices directly or indirectly though any of its policies.

A spot-price based GIC does not and will not, in any way, amount to a back door reimposition of wellhead price controls. Wellhead price controls were based on original accounting costs. When the price of oil quadrupled, the value of natural gas soared, yet the accounting costs of existing gas did not change at all. Gas could be sold for market value on the intra-state spot markets, but only at accounting cost prices in interstate markets. The result was the severest shortage of interstate gas we have ever experienced. Under a spot-price based GIC, prices can respond to changes in supply and demand, whether they mean higher or lower prices.

It is this competitive market demand which will largely determine the appropriate amount of exploration and development. In no way would implementation of a competitively-priced GIC be equivalent to a reimposition of wellhead controls.

Competition in today's gas markets makes it difficult for pipelines to continue to sell gas at the pipeline's WACOG that is substantially above the spot price. As recent experience demonstrates, attempts to charge such a WACOG results in the pipeline losing sales to the spot market directly or to others such as marketers. In the current gas market, the pipeline must be able to respond quickly to changes in market conditions if it is to remain a seller of gas. The proposed competitively-priced GIC makes it possible for this to happen.

Question No. 3(a): Section 601 of the NGPA provides for the automatic passthrough by pipelines of amounts paid for the purchase of natural gas. As a matter of law, do you believe that the spot market GIC, or any amount which is other than that which a pipeline actually pays for gas (be it higher or lower), can be deemed to be just and reasonable without violating the spirit and letter of section 601?

Answer: Yes. Section 601 of the NGPA requires the Commission to allow the pipeline the opportunity to pass through the prices paid by the pipeline to producers for natural gas. Section 601 does not guarantee that the pipeline can recover its actual cost of gas if the market price is less than the pipeline's gas costs. Therefore, Section 601 does not prevent a pipeline from charging a lower price for its sales gas, than its actual gas costs, in order to sell gas. Indeed, that was one of the purposes of Section 601, to permit the wellhead price to be more responsive to demand. Conversely, if the market price is higher than what the pipeline has paid, Section 601 does not prevent a pipeline from charging the higher price. This, again, would be consistent with the underlying purpose of Section 601 to make the wellhead prices responsive to demand.

Question No. 3(b): If you believe that the Commission has the authority to hold as just and reasonable amounts other than that which a pipeline actually pays (absent fraud, abuse or other similar grounds), please provide the Subcommittee with a full legal analysis supporting that view.

Answer: The NGPA deems prices paid by the pipeline to be just and reasonable under the NGA. However, neither the NGPA nor the NGA require the pipeline to recover those prices through a PGA clause or other tracking mechanism. For example, before 1972 the Commission did not track gas costs in pipeline rates, but rather, projected the level of gas costs that would be incurred by the pipeline when setting the pipeline's rates. Whether the rates actually recovered the pipeline's gas costs, or over-recovered those costs, depended on the accuracy of the cost projections made at the time the rates were set. Therefore, the statutes do not require that pipeline sales rates always equal, or track, the pipeline's gas costs.

While the NGPA requires the Commission to permit the pipeline the opportunity to pass through the prices paid to producers for natural gas, the NGPA does not require that the pipeline pass through those prices. For example, the pipeline may elect to charge a price for its sales gas that is lower than its costs to sell gas. In that event, the Commission is not imposing a lower price or limit. Rather, it is the pipeline that is accepting a lower price to remain competitive to market its product. If the market price is higher than the pipeline's contract prices with certain producers, the NGPA does not prevent the pipeline from charging the market price to its customers. This will permit the price of gas to reflect the current demand for gas and send accurate signals to producers with respect to their prices so that demand and supply can balance. The NGPA's market price or commodity value approach for pricing gas is entirely different from the embedded gas cost approach that was responsible for past gas shortages.

In any event, pipelines have a portfolio of gas supplies available to them at various prices and under various contract terms. Pipelines and producers have been renegotiating their contracts to have market responsive pricing provisions. Hence, as the market price goes up the pipeline's costs will likely rise also so that its rates are unlikely to be significantly higher than its costs.

Where a pipeline's customers have the option of buying gas in a competitive market, the pipeline's charges will be constrained by a ceiling established by supply alternatives available to customers. Therefore, a pricing scheme for a pipeline's gas that is based on this will fulfill the intent of the NGPA that market forces, and not costs, play a "more significant role in determining the supply, the demand, and the prices of natural gas." Transcontinental Gas Pipe Line Corp., v. State Oil and Gas Board of Miss., 474 U.S. 409, 422 (1988).

The Commission, of course, would continue to monitor the functioning of particular gas markets to ensure that pipeline prices continue to be subject to competitive market forces. If a market is not properly functioning in a competitive manner, the Commission has the regulatory tools available to take corrective action.

Question 3(c): It is my understanding that the Commission's February draft order regarding Transco's GIC, which was made available for public viewing on the day of the Commission's February 15, 1989 meeting, held the spot market price to be just and reasonable. Because it was made available to the public at that time, please provide the Subcommittee with a copy of that draft order.

Answer: A copy of the draft order is attached.

RP-1(B) DRAFT

FEB 15 1989

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

CERTIFICATES: GAS INVENTORY CHARGE

Before Commissioners:

Transcontinental Gas Pipe Line) Docket Nos. CP89-728-000;
Corporation) CP88-391-000; and
) RP88-167-000

ORDER ISSUING LIMITED TERM CERTIFICATE FOR INTERIM GAS INVENTORY CHARGE

On May 12, 1988, Transcontinental Gas Pipe Line Corporation (Transco) filed in Docket Nos. CP88-391-000 and RP88-167-000 an "Application for Certificate of Public Convenience and Necessity for Service Restructuring, For Abandonment Authorizations, and For Approval of Tariff Changes Pursuant to Stipulation and Agreement." 1/

Transco operates both as a merchant of gas under various sales rate schedules and as an open access transporter under Part 284 of the Commission's regulations. In its filing, Transco proposes to comprehensively restructure its sales, transportation, and storage services to bring its "system fully into the post-Order No. 436 era of open access and market-oriented services." 2/ Among other things, Transco proposes a gas inventory charge consisting of daily and monthly option service charges and a gas commodity charge which employs a price formula keyed to Gulf Coast spot market prices.

In a companion order issued this date, the Commission is setting Transco's gas inventory charge proposal for hearing. In the instant order, the Commission offers a limited term certificate to Transco which will permit Transco to implement an interim gas inventory charge upon its acceptance of the proffered certificate while the Commission considers a permanent gas inventory charge for Transco. The Commission is offering Transco a limited term certificate for a gas inventory charge for two reasons. First, most of the intervenors in Docket Nos. CP88-391-000 and RP88-167-000 either supported or did not oppose the implementation of a gas inventory charge. Second, the Commission believes that in the current economic and regulatory environments

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1/ Transco supplemented its filing on May 20, 1988.

2/ Transmittal Letter at 4.

for the natural gas industry, it is in the public interest for interstate gas pipelines such as Transco to implement gas inventory charge mechanisms as soon as possible in order to limit any gap between the recovery of past take-or-pay costs and future take-or-pay costs. This interim implementation of the gas inventory charge mechanism will benefit both pipeline and customer by enabling them to plan and coordinate their relationship and their relationships with others pursuant to current needs and within the framework of a rational, efficient pricing structure. As the Commission stated in Order No. 500:

> The new rate design is intended as a future-looking mechanism to recover the costs of contractually committing gas service that has been tailored to meet the customer's nominations whenever fewer than nominated volumes (or a reasonable percentage of nominated volumes) are taken by a customer, who is fully aware that such charges would be currently assessed on a monthly basis, based on its own service nomination. In brief, the Commission is seeking to establish a rational, efficient pricing structure for the pipeline merchant function with emphasis on reciprocity and consideration of service obligations under the increased options available to a pipeline's sales customers. 3/

The Commission invites other pipelines to file for a similar limited term certificate for an interim gas inventory charge along the lines of the instant certificate.

I. The Relationship of the Dockets

Transco filed its Application in Docket Nos. CP88-391-000 and RP88-167-000. The Commission is offering this limited term certificate to Transco in Docket No. CP89-728-000. Intervenors in Docket Nos. CP88-391-000 and RP88-167-000 are being made intervenors in Docket No. CP89-728-000. The dockets are not consolidated. Hence, all petitions for rehearing or other requests with respect to the instant certificate should be filed only in Docket No. CP89-728-000. In addition, the Commission is issuing Transco a certificate for interruptible sales service in Docket No. CP89-759-000 and will be considering its proposal for a certificate for open access storage in another docket.

3/ FERC Stats. and Regs. ¶ 30,761 at p. 30,794 (1988).

II. Transco's Proposal

Transco's proposal consists of a daily and a monthly option service charge and a gas commodity charge which employs a price formula keyed to Gulf Coast spot market prices. 4/ Transco's option service charges are derived by multiplying various premia determining percentages times the gas commodity charge. Transco submitted in Appendix B2 to its application an examination of the future "costs of providing secure, long-term gas supply" for purposes of determining the premia used in developing its option service charges.

In the companion order, the Commission is setting Transco's proposed gas inventory charge for hearing where Transco must demonstrate that its markets are subject to sufficient competition to make its rates just and reasonable or, if they are not, that its proposed premia and spot price formula are in the public interest. In the interim, the Commission has concluded that Transco's basic concepts -- namely, the use of spot market prices as the basis for the gas commodity charge and a premium times that price (percentages) as the option service charge -- are in the public interest. Accordingly, the Commission is offering Transco a limited term certificate for a gas inventory charge which consists of a gas commodity charge based on the spot market price composite as derived pursuant to Appendix A to this order 5/ and a gas inventory (option service) charge derived as discussed below.

For the reasons stated below, the Commission finds that this certificate is required by the public convenience and necessity.

4/ Transco's proposal is described in greater detail in the companion order in Docket No. CP89-391-000, et al.

5/ Part VI sets out the adopted spot price composite calculations. In brief, the price will be a composite price made up of the average of spot prices reported by four independently published periodicals for those geographic areas closest to Transco's sources of gas supply. The composite price for a given month will be the average of the preceding month and will be the maximum price that Transco may reflect for the gas components of its rates. Transco may reflect a lower price in the gas component of its commodity rates. But the option charge could still be based on the spot price index.

III. The Spot Price Concept

The Commission believes that a composite price based on spot market prices can serve as an appropriate basis for sales service (the gas commodity charge) and for the gas inventory charge if the following four conditions are satisfied: (1) that the spot market functions properly, in the sense that price responds to changes in the demand and supply of gas, (2) that the spot price average used by the pipeline is representative of actual spot prices in supply areas from which the pipeline receives its gas, (3) that such spot price reports be readily available (by subscription or otherwise) to the pipeline, its customers and to the Commission, and (4) that such reports should be published at least monthly by an entity not engaged in the business of buying, selling, transporting or brokering natural gas.

The Commission has examined the available data on the spot market (see Appendix A to this order) and concludes that it is a well functioning market in the sense that it is broad (spot sales as a percent of total throughput are variously estimated at between 35 and 70 percent), and that it responds to forces of supply and demand (i.e., there is a pronounced seasonal effect on spot prices).

The Commission has also examined the behavior of spot price series published in four different trade periodicals and concludes that the series are in general agreement with one another, and that the spot prices respond to the forces of supply and demand. Thus, the Commission believes that spot prices can serve as an appropriate basis for sales service and the gas inventory charge and that spot prices published in the four trade periodicals examined are representative of spot prices in the supply areas to which they refer.

The Commission concludes that spot market prices may serve as the basis of gas commodity and gas inventory charges because such prices are representative of market prices and are therefore just and reasonable and in the public interest. 6/ In addition, the use of spot prices is in accord with the intent of Congress in enacting the Natural Gas Policy Act that market prices play a "more significant role in determining the supply, the demand, and the price of natural gas." 7/

6/ FPC v. Sunray Dx Oil Co., 391 U.S. 15, 25 (1967) ("[T]he 'true' market price [is] the just and reasonable rate")

7/ Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Miss., 106 S. Ct. 709, 717 (1986).

IV. The Gas Inventory Charge Premium

A. Theory

The Commission believes that a gas inventory charge may be developed from the perspective of the value of gas supply contracts to the pipeline and its customers. The focus is on the aggregated value of the pipeline's inventory of contracts.

From the pipeline's perspective, entering into gas supply contracts with producers is a necessary step in the process of offering firm merchant sales service to its customers. Without those contracts the pipeline could not provide reliable firm sales service. The benefits associated with those contracts are not realized, however, without some obligations and financial risk to the pipeline. For example, gas supply contracts can be viewed (at least in an operational sense) as providing something of intrinsic value to the pipeline and customers demanding merchant service by the pipeline. But the pipeline may, nonetheless, be exposed to financial risks contained in the contracts. If the pipeline does not perform in accordance with the contracts, the pipeline may be exposed to the incurrence of added costs (e.g., take-or-pay liability claims, contract reformation costs, etc.).

For the purposes of quantifying a gas inventory charge, an analogy can be drawn between compensation for the "exposed value" of net depreciated fixed assets and compensation for the pipeline's exposure under its inventory of gas supply contracts. This approach derives the gas inventory charge based on the value of the pipeline holding an inventory of gas supply contracts for the benefits of its customers, not on the pipeline customers' "deficiency quantities." In other words, this approach derives the gas inventory charge by balancing the gas supply insurance for the pipeline's customers for the pipeline's inventory of gas supply contracts and the costs to the pipeline of holding and managing that inventory of contracts.

The approximate value of an inventory of gas supply contracts can be established for these purposes based on the expected value for which the pipeline could sell the gas in the competitive market. Although that price would be expected to vary over time, the adoption of the monthly average spot prices in Transco's major gas supply areas is reasonable. (See Footnote 5 and Appendix A.)

Periodic changes in the spot price index reflect market changes in natural gas supply and demand and incorporate the effects of inflation. This approach establishes the gas inventory charge based on an "instantaneous charge." By using a "variable" price index there is no need for any discounting (in a "present value" context) or for factoring in inflation of future expected prices for the purposes here.

Also, the instantaneous charge does not require any discounting (in a "present value" context) of the quantity of gas to be produced at future dates under individual or aggregated contracts. Rather, this approach assumes that the pipeline will maintain an inventory of gas supply contracts consistent with the service demands of its customers. That is, the pipeline would be expected to add new contracts where they are needed and shed other contracts when appropriate.

The net effect is that the pipeline would be expected to maintain an inventory of contracts, providing the aggregate instantaneous deliverability, long-term reserves, and contract provisions consistent with the merchant service demands of its customers. The mix of physical features (e.g., deliverability, rate of production decline, expected depletion period, etc.) related to the gas supply supporting individual contracts, and the contract parameters (e.g., price, take requirement, make-up provision, etc.) would be expected to satisfy these requirements. Thus, there is no need to examine the operation of individual contracts.

2. Quantification

The essential question is how to best recognize through the pipeline's current rates the value to the pipeline's customers for risks undertaken by the pipeline in assembling an inventory of gas supply contracts, whether short or long-term, needed to fulfill its merchant function.

In the past, the pipeline has been compensated for its take-or-pay costs by including gas prepayments in the pipeline's rate base and imputing the pipeline's overall pre-tax rate of return allowance to such costs. However, the pipeline forgoes this rate treatment (and any other means of collecting take-or-pay costs) when it elects the gas inventory charge. Thus the risks attending the inventory of contracts held by the pipeline are shifted entirely to the pipeline.

The Commission believes it is reasonable to compensate the pipeline for costs reasonably associated with the risk of holding gas supply contracts at the same level that the Commission compensates the pipeline for holding its physical assets. That is, assuming the approved pre-tax return utilizes the current 34% Federal tax rate, we see no reason to adjust the pipeline's approved cost of capital allowance for use in developing the interim gas inventory charge. For Transco, the cost, based upon its current effective pre-tax rate of return, is 15.39 percent. 8/

The next step in quantifying the interim gas inventory charge developed here requires an estimation of a reasonable overall take-or-pay level to assign to the pipeline's inventory of contracts. On December 16, 1982, the Commission adopted section 2.103 of the Commission's regulations which established 75 percent of deliverability as the take level above which no presumption of prudence would attend for new contracts. 9/ Prior to this time, new gas supply contracts typically incorporated considerably higher take levels (*e.g.*, 90 percent was not uncommon). In prescribing the 75 percent take-or-pay factor, however, the Commission made clear that 75 percent was the upper limit, and that it was not intended to be a floor. Nothing stated here should in any way be construed as suggesting that the 75 percent factor is anything other than an upper limit for use in the gas inventory charge formula described here.

Thus, it would not be appropriate to develop the interim gas inventory charge simply by multiplying the pipeline's pre-tax rate of return by the price of the gas. That is because the pipeline is not at risk for the full quantity of gas available under its inventory of gas supply contracts. It is only at risk for the quantity of gas subject to the take-or-pay requirement. And, as explained above, there is a ready reference point that recognizes that the pipeline is not at risk (or certainly it should not be) for the full quantity of gas supporting the

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8/ The 15.39 percent pre-tax rate of return is based upon the following data from Transco's Docket No. RP87-7 which underlies a cost of service settlement that has been approved by the Commission.

Capital	Structure	Capital Cost	Weighted Capital Cost	Pre-Tax Cost (w/ 37.4% Composite Tax Rate)
Debt	49.81%	10.16%	5.06%	5.06%
Preferred	19.04	9.47	1.80	2.87
Equity	31.15	.00	4.67	7.46
Total	100.00%		11.53%	15.39%

9/ The Commission has referred to this policy in addressing take-or-pay issues in its orders. See, *e.g.* *State of Michigan and Michigan Public Service Commission v. Trunkline Gas Co.*, 24 FERC ¶ 61,013 at 61,,060 (1983) and *Tennessee Gas Pipeline Co.*, 26 FERC ¶ 61,102 at 61,247-48 (1984).

contracts. That factor is the 75 percent deliverability factor that appears at section 2.103 of the Commission's regulations.

The Commission therefore adopts the 75 percent factor as a reasonable generic approximation to compensate for the exposure that the pipeline would have under the operation of take-or-pay provisions in its contracts. 10/ This level of inferred take requirement should result in adequate compensation for the risks of exposure to take-or-pay and contract reformation costs undertaken by the pipeline. At the same time, the "reconciliation mechanism" -- which is described below -- will provide adequate protection to the pipeline's customers.

In summary, the approach developed here recognizes and accounts for several features. First, it recognizes that the gas supply available to the pipeline and its customers through the pipeline's inventory of gas supply contracts provides something of value to the pipeline and its customers, i.e., gas supply insurance. This inventory of contracts takes on similarities to and provides the equivalent operational functions (in an operating sense, but not in a financial accounting sense) as though the pipeline itself owned the gas supply supporting the contracts. This feature is recognized for ratemaking purposes by imputing an economic value based upon the pipeline's overall pre-tax rate of return and the price at which the gas would be available from time to time to the pipeline's customers.

Second, the approach recognizes that the pipeline is not at risk for all of the gas supply supporting the inventory of contracts held by the pipeline, but only to the extent of its take-or-pay and other contract requirements. This feature is recognized for ratemaking purposes by, effectively, viewing the pipeline's inventory of contracts as one "umbrella contract" and imputing the generic 75 percent take factor discussed above. The use of this factor also serves as an acknowledgement of the Commission's general policy against take obligations above the 75 percent threshold, thereby encouraging continued contract renegotiations of contracts that have not yet been reformed to reflect the realities of the natural gas market.

10/ We recognize that Transco, like most other pipelines, has extensively renegotiated its gas supply contracts to incorporate lower take-or-pay levels and more favorable pricing provisions. For example, information in Transco's Docket No. RP87-7 proceedings apparently indicates that Transco's average take-or-pay requirements were about 85 percent of gas under contract during the 1980-85 period and about 74 percent during 1986.

Under the approach outlined here, the overall level of Transco's gas inventory charge would be established by the product of the following three factors:

(1) The monthly average price of spot purchases, estimated for illustrative proposes here to be about $2.00/MMBtu;

(2) Transco's overall pre-tax rate of return, currently 15.39 percent; and

(3) An inferred overall take requirement of 75 percent under Transco's inventory gas supply contracts.

Those factors in this illustrative computation support a gas inventory charge level of : $2.00/MMBtu x 11.54 % = 23¢/MMBtu. A customer's monthly entitlement times 23¢ equals its total monthly option charge obligation.

The option service and gas commodity charges together are intended to cover Transco's total payments to producers such as the cost of gas Transco purchases (including any premia paid for long-term contracts)~~,~~, option charges to producers, prepayments, and contract reformation costs.

3. Reconciliation Mechanism

As noted above, the interim gas inventory charge has been based on factors that are known at the time of its authorization (*e.g.*, pre-tax rate of return, imputed take requirement) and the spot price of gas -- which, although not known now, will be based on future events (*i.e.*, changes in spot prices) and will be known as those future events occur. What the Commission does not know, and is unable to project at this time, is the pipeline's actual level of gas options payments, take-or-pay payments, contract reformation costs, and other costs related to its merchant function. That is, because we are dealing with a new service, there are no "base period" data upon which projections of these future merchant-function costs could be made. To address this concern and to guard against excessive charges to the pipeline's customers, a "reconciliation mechanism" is adopted.

The reconciliation mechanism is straight forward. It compares at the sum totals of actual revenues and actual expenses for the following:

(1) Transco's revenue collection through (a) its charges for the gas actually sold by it as a merchant (here set at the spot prices as a maximum), and (b) its gas inventory charge (here set at 11.54 percent of the spot price index); and

(2) Transco' actual payments for (a) the gas it purchased and resold as a merchant, and (b) carrying charges on gas options payments, prepayments, take-or-pay buy-out/buy-down settlement payments, and contract reformation costs (less any amounts recovered under the litigation exception of its Order No. 500 passthrough mechanism).

Within ninety days following the end of the limited term certificate authorizing the instant gas inventory charge, Transco must file a reconciliation report with the Commission. To the extent that the report includes material that Transco believes is confidential and proprietary (e.g., take-or-pay settlement payments, etc.), Transco will be free to seek confidential treatment of any such material consistent with the Commission's regulations. Customers and other affected parties will be entitled to comment on Transco's report.

To conclude, the "reconciliation mechanism" for the interim gas inventory charge should be based on the difference between Transco's total collection of revenues and total expenses attributable to its merchant function during the period that the gas inventory charge was in effect. Any excess revenues must be refunded to Transco's customers in proportion to their monthly nominations during the period that the interim gas inventory charge was in effect. Interest on any over collections should be imputed from the end of the period that the interim gas inventory charge is in effect at the rate of interest for refunds specified in the Commission's regulations. Transco would be at risk for any under collections of revenue, and Transco would not be permitted to file to recover the costs of any under collections. We believe these procedures strike an appropriate balance between the needs of Transco for funding its merchant function and protection against any excessive charges to Transco's customers during the period that the interim gas inventory charge is in effect.

V. Related Requirements

The Commission believes it in the public interest to condition the instant certificate to ensure that the gas inventory charge is not anticompetitive or unduly discriminatory. These conditions are as follows:

(1) The certificate shall be for a period of two years from the date of Transco's acceptance of this certificate. This will provide adequate time for hearing and decision on and implementation of Transco's gas inventory charge proposal in Docket No. CP88-391-000. In addition, this will provide sufficient time for Transco to implement the interim gas inventory charge

and will provide maximum certainty to Transco and its customers.

(2) Transco must use its existing firm sales rate schedules for implementation of the interim gas inventory charge. 11/ Transco must use the gas inventory charge mechanism for service under all its firm sales rate schedules. 12/ This will enable Transco's customers to continue service under existing rate schedules during the period of the interim gas inventory charge and avoid disruption in service at the conclusion of the two-year period if Transco's proposed gas inventory charge has not gone into effect.

(3) Transco must implement a 100 percent standby service under all its firm sales rate schedules whereby its firm sales customers may take their full daily entitlements as either sales, transportation, or any combination of sales and transportation. Transco's standby charge must be separately stated in each firm sales rate schedule and must be designed as set forth in the companion order setting its application for hearing. 13/ Transco's transportation under standby service shall be performed under its firm transportation rate schedule (Rate Schedule FT). This condition ensures that customers will make their gas purchase decisions based solely on the price of gas.

(4) Transco must permit its firm sales customers to freely nominate both monthly and annual requirements, provided that a customer's total of monthly entitlements cannot exceed its nominated annual entitlement. Any customer which nominates monthly and annual entitlements below its full current contract demand level during the

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11/ Transco will need to modify its existing rate schedules to reflect the option service and gas commodity charges. Moreover, Transco should revise its tariff to include the instant methodology for calculating the option service and gas commodity charges.

12/ Rate Schedules G and OG may have one-part rates which include the effect of an imputed gas inventory charge based upon the imputed load factor for those schedules.

13/ *See* Part IV. B.1. of the companion order. The Commission repeats that if a shipper pays for gathering as part of the cost of Transco standing ready to sell gas, the shipper should not also pay for gathering as part of its transportation charges.

period of this gas inventory charge shall be considered to have consented to abandonment of the amount not nominated. However, subject to the above, a customer can on any given day take its full daily entitlement. 14/

(5) Transco must permit its firm sales customers to convert up to 100 percent of firm entitlements to firm transportation service. Such conversions shall be permanent and not solely for the term of this interim certificate. Provisions (4) and (5) will enable Transco to tailor its gas supply to meet customer nominations without guessing what supply may be needed or shed in the future.

(6) Transco must terminate the operation of its purchased gas adjustment (PGA) clause for the term of this interim certificate and shall be entitled to direct bill its Account No. 191 balance, including transition costs subject to the conditions set forth in the companion order. 15/ This will more closely match cost responsibility with cost incurrence and remove future uncertainty for Transco and its customers as to the disposition of the monies in that account. Transco may only reinstate its PGA by complying with section 154.303(b) of the regulations or by establishing its right to a waiver therefrom.

(7) Transco will be subject to the reconciliation mechanism discussed above. Transco must provide a reconciliation study as set forth above within 90-days of the end of this limited term certificate and refund any overcollections.

(8) Transco must remain an open access transportator under Part 284, Subpart G of the Commission's regulations for the term of this certificate.

14/ See 18 C.F.R. § 2.105 (1988). Transco may not impose a nomination threshold if it accepts this certificate. See Part IV, B.2. of the companion hearing order.

15/ See Part IV, H. 5. of the companion hearing order. In summary, Transco must permit its customers to pay the direct bill either in installments or in a lump sum; Transco's customer may challenge the prudence or reasonableness of the direct billing amounts; and Transco must make any applicable refunds to its customers.

(9) Transco must remove its restrictions on its customer's ability to inject gas purchased from others into contract storage and permit flexible receipt points in its Rate Schedule FT contracts. 16/

(10) Transco is also subject to the conditions discussed in the companion hearing order. It must

(a) continue to use its current authorized overrun and scheduling penalties (Part IV. G.1. and 2.)

(b) retain its present requirement for information concerning affiliates in requests for transportation service. (Part IV.G.3.)

(c) allocate priority to interruptible transportation customers as discussed in Part IV.G.7

(d) file revised tariff sheets with respect to gas supply curtailments (Part IV. H.4.).

(e) comply with the exculpatory language discussion of Part IV.B.5.

(f) comply with the fuel requirements discussion of Part IV.B.15.

(g) comply with the producer settlement cost and take-or-pay (including, without limitation, cross-crediting) discussion of Part IV.H.3.

In addition, Transco's acceptance of this certificate shall constitute a waiver by it of its right to seek judicial review of each and every aspect of this order. The Commission believes that this is appropriate because Transco's acceptance of this certificate is voluntary. It may reject the certificate and retain its current sales service pricing procedures and pursue its gas inventory charge proposal in the hearing set by the companion hearing order. It would be unfair if it could accept the certificate which is a package and litigate its individual parts.

The Commission will also require Transco to make a full Section 4 rate filing under Section 154.63 of the regulations within 90 days of its acceptance of the certificate because

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16/ Transco permits its firm transportation customers to add or delete receipt points on 30 days written notice.

Transco does not have a current rate case pending [17] or rates which were established based on a base period ending within 12 months from the date this certificate would go in effect. hence, such items as Transco's rate of return on equity and throughput may be out of date and its allocation of costs and levels of service may not be in sync.

At a hearing held on February 15, 1989, there was received and made a part of the record in this proceeding all evidence, including the Application and exhibits thereto submitted in support of the authorization herein.

The Commission will also require Transco to pay a filing fee for this certificate as its previous filing fee covered only the certificate application filed in Docket No. CP88-391-000. [18]

The Commission orders:

(A) Upon Transco's unconditional acceptance and the payment of a filing fee, a limited term certificate of public convenience and necessity is issued to Transco in Docket No. CP89-728-000 authorizing Transco to institute a Gas Inventory Charge for two years as described in the body of this order.

(B) The certificate issued in Ordering Paragraph (A) above is subject to the terms, conditions, and requirements set forth in the body of this order and the ordering paragraphs below.

(C) The intervenors in Docket Nos. CP88-391-000 and RP88-167-000 are intervenors in Docket No. CP89-728-000.

(D) Section 157.20(a) of the regulations shall not apply and Transco shall notify the Commission of its acceptance of this limited term certificate within 30 days from the date of this order. If, however, applications for rehearing are pending at the close of the 30 day period, the above-mentioned acceptance shall be made 30 days after the date the applications are resolved by the Commission.

(E) Transco must permit its customers to nominate both sales and transportation levels within 45 days after it accepts the instant certificate.

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[17] In Docket No. RP87-7 the Commission has approved a settlement that resolves the cost of service, overall throughput level, and many rate design issues. Certain specific issues were reserved by the settlement.

[18] Because RP88-167-000 has been terminated (see Part III of the companion hearing order), Transco may credit the filing fee therefor against the instant filing fee.

(F) Transco should file pre forma revised sales rates and tariff sheets to reflect the other revisions to the terms and conditions of its tariff concurrently with its acceptance of this certificate. Those rates and revisions may become effective no earlier than the first day of the month following the period for customer nominations. Transco's filing shall be under Section 4 of the Natural Gas Act and Part 154 of the Commission's regulations.

(G) Transco's rates filed pursuant to this order shall be subject to the final orders in Docket RP87-7-000 and Transco's compliance with the Commission's Opinion Nos. 260, 260-A, and related orders.

(H) Transco must make a full Section 4 rate filing under Section 154.63 of the regulations within 90 days of acceptance of the certificate.

(I) Transco will be at risk for any undercollections of non-gas costs during the period between the effectiveness of its revised sales rates authorized by this order and the effective date of the new sales rates filed pursuant to Ordering Paragraph (H) above.

(J) Transco must file with the Commission, on a monthly basis, tariff sheets reflecting the spot price utilized for purposes of computing the commodity sales rates and the options service charge.

(K) Transco's acceptance of this certificate shall constitute a waiver of its right to seek judicial review of each and every aspect of this order.

(L) Transco may recover its Unrecovered Purchased Gas Costs in Account No. 191 by direct billing as set forth in the text above.

(M) Transco may only reinstate its PGA by complying with section 154.303(b) of the regulations or by establishing its right to a waiver therefrom.

By the Commission.

Secretary

APPENDIX A

Question No. 4(a): Assume for the purpose of analysis that notwithstanding the clear meaning of section 601 of the NGPA, the Commission somehow found the authority to deny the passthrough of gas purchase amounts above some Commission-established level -- say spot market prices -- as not being just and reasonable.

(a) As a practical matter wouldn't that mean that notwithstanding the recent Congressional elimination of wellhead price controls, the Commission could reimpose wellhead price controls, albeit indirectly?

Answer: The Commission does not have the authority to deny the pipeline's recovery of its gas purchase amounts absent a finding of fraud, abuse or similiar grounds. This is because the denial of the recovery of amounts paid by the pipeline could have the effect of indirect price controls, contrary to the purpose of the NGPA. As a result, the Commission has not proposed to establish price levels that would serve as a cap on the pipeline's passthrough of gas costs in the absence of cases where the Commission has found fraud, abuse or similar grounds for doing so. Rather, the Commission has proposed to allow pipelines to recover their gas costs in two parts, one part to be based on the market price, and the other part to recover the difference between the market price and the pipeline's total gas costs.

Question No. 4(b): Wouldn't that action give pipelines a legal basis to assert force majeure, or exercise FERC out and market-out clauses, or other similar provisions in their contracts with producers, notwithstanding the statement in the NOPPS that the proposed GICs "are in no way intended to affect contractual rights and responsibilities arising under any pipeline's gas purchase contracts"?

Answer: The Commission's denial of passthrough could affect contractual rights and responsibilities arising under any pipeline's gas purchase contracts, depending upon how the parties negotiated the contracts. However, as indicated in answering the prior question, the Commission is not proposing to take such action.

Question 5: The Energy Information Administration of the Department of Energy has provided me an initial impact assessment of the proposed spot market GIC. That analysis shows that had the spot market GIC been in place last year and prices ramped down to spot levels, the producers who sell to the 20 largest pipelines would have lost $1.3 billion last year and $842 million during the first six months of this year. Copy attached.

Has the Commission itself analyzed the impact of the two alternative proposed GICs on wellhead prices, exploration, reserves and production? If yes, please provide the Subcommittee a copy of the analysis.

Answer: Please see the answer to Senator Bingaman's question #1.

Question 6(a): In addition to the policy problems which would be caused by the use of the spot market GIC, the methodology proposed for its calculation also appears to be seriously flawed. On page 7 of the NOPPS the Commission asserts that the competitive price composite of the spot market GIC represents a "true" market price and not a presumed market price. Does the Commission's methodology reflect a pipeline's "true" cost of acquiring gas, or does it instead only create a "presumed" cost of acquiring gas which bears no relationship to a pipeline's WACOG?

Answer: The Commission proposed a methodology for estimating the cost of maintaining competitively priced longer term supplies. The Commission intended that the fixed charge combined with the commodity charge would represent the total cost of longer term supplies. The Commission requested comments on various aspects of its proposed methodology and requested comments on alternative methods that could be used.

In Order No. 500 the Commission recognized that pipelines might need to renegotiate their contracts with producers. In recognition of this, the Commission in Order No. 500 established a passthrough mechanism for the buyout of past take-or-pay costs and the buydown of price or take-or-pay provisions. Pipelines were permitted to submit these filings through March 31, 1989. Through this mechanism the Commission believed pipelines could bring their WACOGs more in line with competitive prices for longer term supplies. The GIC mechanism, also outlined in Order No. 500, was intended to be a forward looking mechanism to deal with future costs of maintaining gas supplies after the pipeline has used the Order No. 500 passthrough mechanism to reform its contracts.

Question 6(b): Is it true that the prices used in the spot market GIC calculations are not weighted by volume?

Answer: The answer for the most part is yes. The Commission is considering as an interim measure, and seeking comments on, use of a composite price of competitive market prices as an appropriate basis for sales service and for the interim gas inventory charge if the following four conditions are satisfied: (1) that the competitive market functions properly, in the sense that price responds to changes in the demand and supply of gas, (2) that the competitive price average used by the pipeline is representative of actual competitive prices in supply areas from which the pipeline receives its gas, (3) that such competitive price reports are readily available (by subscription or otherwise) to the pipeline, its customers and to the Commission, and (4) that such reports should be published on a regular interval by an entity not engaged in the business of buying, selling, transporting or brokering natural gas. Any source that meets these condition can be used.

The trade publications utilized by the Commission in developing the market price in the NOPPS were: (1) Inside FERC's Gas Market Report; (2) Natural Gas Intelligence; (3) Natural Gas Week; and (4) Gas Daily. Of these four sources only one -- Gas Daily -- uses a volumetrically weighted average. Thus, if a pipeline were to utilize Gas Daily solely, then a weighted average approach would be used and to a lesser extent an average would be used if a pipeline included Gas Daily in computing a composite average.

Question 6(c): Would the use of unaudited and unverified data provided by pipelines to trade publications present any potential or incentives for abuse? Has the Commission itself verified that the prices reported to these trade publications are correct?

Answer: FERC has not "verified" the prices published by the trade press. Pipelines have little to gain by manipulating spot prices, since their customers, many of whom have supply alternatives, can go directly to the producers themselves if they believe they can make deals at below the reported spot price.

Nor would they have incentive to manipulate spot to keep prices lower than actual spot prices, since under the interim GIC mechanism they must refund revenues they collect above actual gas costs.

Question 6(d): Does FERC plan on auditing the published data to ensure that it continues to be provided accurately by the pipelines to the trade publication, and published accurately by the trade publications? If not, should the Energy Information Administration be directed to collect and publish the necessary data?

Answer: FERC does not plan to audit the price data published by the trade press. As stated above, pipelines appear to have little incentive to misrepresent prices. If they do, it is highly likely that producers or customers will bring it to the Commission's attention. In Order No. 50, the Commission mandated that monthly changes in the maximum lawful prices for natural gas be based on the prices for No. 6 fuel oil, based on prices reported in Platt's Oilgram. While EIA collected data on fuel oil prices, the lag was too long to base the monthly changes on the EIA data. We are unaware of any problems produced by this reliance on private, unaudited trade publication price data.

Question 7: I understand that the Commission's policy has been to permit GICs only if it can be shown that "sufficient" competition exists in the pipeline's sales market. Can there be "sufficient" competition if pipeline firm transportation services are not comparable in quality to their sales service? Are they now comparable? Do you believe that a necessary precondition of any interim or permanent GIC is that firm transportation service of a pipeline must be fully comparable to its sales service?

Answer: The Commission believes that, currently, the quality of pipeline sales service may be higher than that provided under firm transportation. Consequently, the Commission has required parties in the GIC proceedings to address changes or certificate conditions that may be required to make firm transportation service and sales service comparable.

Question No. 8: FERC Order No. 500 has been an "interim" order for such a long time it can, for all practical purposes, be called a "final" order. Is this what we can expect to happen if the Commission implements "interim" GICs?

Answer: The term "interim" GICs refers to the fact that the Commission will approve a limited-term GIC for a pipeline pending action on its proposed permanent GIC. One of the conditions proposed for accepting applications for an interim GIC is that the pipeline must also have applied for a permanent GIC. The purpose of an interim GIC is to provide a means to avoid a reoccurrence of large unfunded take-or-pay liabilities while the Commission decides the terms and conditions for a pipeline's permanent GIC. The Commission is committed to developing a permanent means for pipelines to recover their inventory costs on a current basis in a manner that is consistent with the competitive market fostered by the NGPA.

Question 9(a): The Illinois Commerce Commission stated in its comments to FERC that the proposed:

> . . . reconciliation procedure, when combined with a demand-based IGIC, creates the opportunity for pipelines to severely harm the competitiveness of the spot market. It does so by providing pipelines with a costless opportunity to subvert the spot market with their customers' dollars. The proposed demand-based charges (based on the spot price of gas, the pipeline's rate of return, and a required gas take percentage) and the commodity price (limited to the spot price) will be very similar across pipelines. However, the incurred cost, based on each pipeline's portfolio of contracts and take-or-pay charges, may differ substantially. Pipelines which anticipate that their revenues under the IGIC would exceed their incurred costs under this procedure, could costlessly meet the spot market with superior firm service and force their spot supply competitors from the market.
>
> The ICC does not believe that the FERC should encourage pipelines to employ an IGIC to enable them to regain monopoly control over the spot market. To do so would be to reverse the enlightened FERC policies which have permitted a competitive spot market to flourish. The potential harm to the competitiveness of the spot market makes the demand-based IGIC unacceptable. Therefore the ICC believes that the demand-based IGIC proposal should be withdrawn from the final policy statement.
> (ICC comments, pp 2-3)
>
> (a) Is the Illinois Commerce Commission right? Could a pipeline use GIC over-collections to make system supply gas super-competitive with spot-market gas? What impact would that have on the spot market price for gas? Would that create an "unlevel playing field"?

Answer: The Illinois Commerce Commission correctly observes that it may be possible for some pipelines with a competitively-priced IGIC to over-recover gas costs. This would happen when the pipeline's WACOG was less than the spot price or when the WACOG exceeded the spot price by less than the demand charge. Because any over-recovery would require refunds, the marginal cost of acquiring pipeline system supply (spot price + demand charge - refund) would be less than the marginal cost of acquiring spot market gas on a stand-by basis (spot price + demand charge).

The proposed competitively-priced IGIC is not likely to result in widespread over-recovery of gas costs, as the ICC fears. It would be contrary to historical experience for a significant percentage of pipelines to have WACOGs consistently at or below seasonal spot market prices. Thus, it is the Commission's judgment that concerns about system-supply being super-competitive and creating an "unlevel playing field" are misplaced.

Question 9b: It would appear that the proposed reconciliation mechanism would give pipelines an interest free loan for up to two years. Is that intended, and is that good policy?

Answer: In its Notice of Proposed Policy Statement the Commission stated that:

> "Interest on any over collections would be imputed from the end of the period that the interim gas supply charge is in effect at the rate of interest specified for refunds in the Commission's regulations. The pipelines would be at risk for any under collections".

As set forth in the proposed policy statement, the Commission proposes to provide the pipeline companies the full extent of the interim GIC for the purpose it was intended, and not to attach an interest obligation during the interim period. The intention is to allow pipelines within certain parameters and flexibility to provide for all of their gas costs, take or pay costs, buy out and buy down costs, premiums, and/or contract settlement costs (considering that pipelines are at risk and may not surcharge for any undercollections during the period). The Commission considered that supply costs are not always matched within specific time periods, and, therefore, dissimilar from the PGA mechanism do not require full interest bearing accounts. Also, the Commission considered that pipelines may need this embedded flexibility to deal with producer obligations during any negotiating process that occurs during the interim period.

Requiring the creation of an interest bearing account would raise the level of the interim GICs while potentially hampering the effectiveness. Additionally, as a condition of receiving a certificate for an interim GIC, the Commission initially has required pipelines to provide its sales customers the right to convert 100% of their sales capacity rights to transportation capacity rights. This affords sales customers who convert an opportunity to avoid a GIC payment.

Question 10 (a): In the recent Panhandle case (Docket No. RP89-185-000) the Commission approved a spot market GIC without any of the projections of the proposed spot market GIC: it allowed the customers of the pipeline to agree to buy a minimum quantity from the pipeline rather than from the pipeline's competitors, and did not require the pipeline to allow customers to nominate volumes freely. Is that anticompetitive or inconsistent with the Commission's open access transportation program?

Answer: The Commission's June 30, 1989 order in the referenced docket, which is still pending rehearing, approved Panhandle's proposed Seasonal Sales Program (SSP) and permitted Panhandle to suspend its regular PGA mechanism while the SSP was in effect. The SSP is not a GIC. It is a mechanism to enable Panhandle to reduce its Purchased Gas Adjustment deferred balance.

The SSP is not anticompetitive. The program simply allows Panhandle an opportunity to enter the natural gas marketplace as a viable competitor. Panhandle's gas cost rate component has been inflexible due to its established long-term contracts. Panhandle's competitors, however, could change price according to season and demand. These variations have given alternate suppliers a substantial competitive edge during the summer months, since market prices are usually lower in the summer. This has resulted in minimal summer sales by Panhandle.

The open access transportation program is not affected by the operation of the SSP. Customers remain free to choose alternate gas suppliers and use the Panhandle system for transportation only, consistent with the Commission's regulations, and customers' contractual obligations.

Question 10 (b): Is it inconsistent with the policy intent of the NOPPS?

Answer: The Notice of Proposed Policy Statement related primarily to the Commission's GIC policy. Panhandle's proposal is not inconsistent with the proposed policy statement, because it does not involve a GIC.

Question 10 (c): Is it inconsistent with the Commission's policy embodied in Order No. 380?

Answer: Order No. 380 dealt with the elimination of variable cost minimum bill provisions contained in gas pipeline tariffs. There are no minimum bill provisions in the SSP. Individual customers are not required to buy any minimum amount. They remain free to purchase gas directly from producers and transport on the Panhandle system without penalty.

Question 10 (d): Did this decision help or hurt producers who sell to Panhandle, and competition generally?

Answer: The SSP will allow Panhandle to actively participate as a merchant in an increasingly competitive marketplace. (Over the past several years, Panhandle has experienced an erosion in system sales of approximately 89 percent.) The end result should be improved competition generally as additional supply options are made available to Panhandle's customers. Additionally, the SSP will likely help Panhandle's producer suppliers as additional production may be necessary if Panhandle is able to successfully increase gas sales.

QUESTIONS FOR THE RECORD FROM SENATOR WALLOP

Question 1: I understand that Kern River recently filed with the FERC an application for an Optional Expedited Certificate. What is the status of this application before the Commission?

Answer: On September 1, 1989, Kern River Gas Transmission Company filed with the FERC its application for an Optional Certificate (OC) in Docket No. CP89-2048-000. Concurrently, Kern River filed its application for a blanket certificate authorizing open-access transportation in Docket No. CP89-2047-000. The filings were jointly noticed by the Commission on September 14, 1989, with comments due October 5, 1989.

Question 2: What is the procedural process through which the application must go before it can be approved?

Answer: Kern River's OC filing is being processed under the Commission's OC procedures. Staff will analyze the filing and any interventions received. Because this is an OC application, market and supply data need not be submitted under the traditional Section 7(c) procedures. Kern River's OC filing involves 25 miles of new pipeline routing not previously analyzed for NEPA purposes; therefore, further environmental review may be necessary. In addition, Kern River's proposal involves interconnection with the facilities of Mojave which also has a related amendment to its optional certificate in Docket No. CP89-1-002 before the Commission which is being reviewed concurrently. Also, staff must ensure that Kern River's proposed rate design satisfies the Commission's OC regulations.

Question 3: How long should this process take?

Answer: The timing of the processing of Kern River's OC will depend in large part upon the length of time necessary to perform an appropriate environmental review under NEPA. Mojave's amendment to its optional certificate which incorporates the joint facilities of Mojave and Kern River does not propose new routing. The environmental review of new pipeline routing of 25 miles can typically be accomplished within three months, if the applicant has filed appropriately detailed environmental report. The actual time required to review the Kern River OC project will also depend on the cooperative efforts of the California Lands Commission. Staff's analysis and recommendation should be before the Commission for decision thereafter.

Question 4: Is this application mutually exclusive with Kern River's previous filing for a standard Section 7(c) permit?

Answer: No, the Commission is processing Kern River's proposals under Section 7(c) and under the optional regulations independently and concurrently. However, if both certificates are issued to Kern River, it will be Kern River's decision as to whether to build its pipeline under Section 7(c) authorization or under its optional authorization.

Question 5: What, if any, further NEPA analysis is required by this application?

Answer: Commission staff has determined at this time that further analysis is required to satisfy the NEPA regulations. Kern River's OC proposal differs from its Section 7(c) proposal by 25 miles which will have to be studied. In addition, Kern River's OC proposal interconnects with the OC amendment of Mojave; therefore, both proposals would be studied together environmentally. Mojave's amendment does not involve new routing.

Question 6: Have there been any intervenors in or protestors to the application?

Answer: Kern River's application was noticed on September 14, 1989 with comments due October 5, 1989. There have been 28 interventions filed in this proceeding, one of which is a protest.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

CHAIRMAN

October 25, 1989

Dear Mr. Chairman:

Thank you for your letter of October 2, 1989, enclosing post-hearing questions from Senator Howard Metzenbaum pursuant to your subcommittee's September 14 oversight hearings on the Federal Energy Regulatory Commission's Proposed Policy Statement on Interim Gas Inventory Charges (GICs) and the Implementation of Permanent GICs.

I appreciate your interest and am pleased to forward the enclosed responses prepared by Commission staff to Senator Metzenbaum's questions. These responses do not reflect the views of other commissioners, which may be submitted to you under separate cover.

If you have any further questions or need additional information, please let me know.

Sincerely,

Martha O. Hesse

Enclosures

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
  Development and Production
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Question 1: FERC's Gas Inventory Charge Policy Statement contemplates that "GIC's" are implemented as add-on charges from pipelines to consumers so as to secure long term gas supplies, and to pay for any new take-or-pay problems between pipelines and producers. Under FERC's Order 500 take-or-pay bailout of pipelines and producers, FERC allowed automatic passthrough of up to 50 percent of past take-or-pay liabilities directly to consumers.

Under the "GIC" policy, residential and other captive consumers, who must rely on pipelines' system supplies of gas, are essentially paying for 100 percent of pipelines' future take-or-pay liabilities. Why is this fair?

Answer:

The passthrough mechanism for the costs of resolving past take-or-pay liability was designed to ensure that all parts of the industry shared on a one-time basis in the burden of resolving the take-or-pay problem that had developed during the transition to competitive wellhead markets for natural gas. To that end, pipelines were required to absorb a share of the costs in order to use a direct bill to passthrough a portion of their take-or-pay settlement costs. Ordinarily, however, a pipeline's rates are designed to recover all the costs of providing a service. In the past, pipeline rates were not designed to recover on a current basis the costs of holding gas in inventory, which led to the take-or-pay problems of the past. Under a GIG, sales customers would pay those costs on a current basis. In addition, under a GIC the pipeline's customers would have the opportunity to freely nominate levels of service in response to the pipeline's stated price or pricing mechanism and to convert to firm transportation. Therefore, to the extent a sales customer does not want to pay the price (including take-or-pay costs) for purchasing from the pipeline, the customers can arrange for alternative supplies.

The court in its review of Order No. 500 declines to review Order No. 500's GIC guidelines for 100 percent recovery of pipelines' future take-or-pay liabilities until the "GIC policy precipitates a concrete case." *American Gas Association v. FERC*, No. 87-1588, *slip op* at 32 (D.C. Cir. Oct. 16, 1989).

Question 2: How is FERC's deficiency-based "GIC" so different from the "minimum commodity bills" that were outlawed by FERC in Order 380 and found by the Court of Appeals to be anti-competitive limitations on customers' ability to shop for the cheapest supplies?

Answer:

The minimum commodity bills of the past were not designed solely for the purpose of recovery of take-or-pay or similar charges as is the deficiency-based GIC mechanism. In addition, a pipeline's customers had no choice as to whether they would be subject to a minimum bill. In contrast, a pipeline's customers will have the choice of avoiding the deficiency charge in whole or in part by exercising a right of conversion to firm transportation and relying on alternative suppliers for their requirements. Moreover, pipeline customers had no right to renominate their firm sales entitlements in connection with minimum bill requirements. The GIC policy permits renominations. Last, while minimum bills inhibited competition, the pipeline's customers' rights of conversion to firm transportation and renomination of levels of sales service in connection with open-access transportation may stimulate competition.

Question 3: In Ohio, and many other consuming states, residential consumers buy their gas from local distribution companies who buy gas from their pipeline suppliers. These pipeline suppliers, such as Columbia and Consolidated, in turn get their gas through pipelines upstream of them that ultimately connect to producing areas. FERC's open access transportation policy contemplates that local distribution companies can get the best mix of lowest cost and secure gas supplies for their customers by shopping for gas. Customers can, in theory, now buy spot market gas supplies, and long term, firm supplies directly from producers, from pipeline suppliers, and from gas marketers or brokers. Yet Ohio local distribution companies who want to buy a mix of low cost spot market gas and long term firm supplies directly from producers are not always able to get firm open access transportation from the producing areas through the upstream pipelines. In other words, if East Ohio Gas wanted to buy a large, long term secure supply of gas from a producer, it may not be able to bring the gas to Ohio consumers even though Consolidated, its direct pipeline supplier and an open access transporter, was paying its upstream pipeline suppliers demand charges for space on their pipelines extending to the producing areas. Other restrictions prevent gas utilities from using gas purchased directly from producers to be injected into underground storage systems near the consuming areas for customers' use during peak winter periods. Some pipelines still require customers to buy higher cost pipeline-supplied gas if they want critical winter storage. Doesn't FERC have to fix these fundamental problems that prevent customers from shopping for a mix of least cost, secure supplies and unbundled cost-based storage and other services before those customers can decide how much they need to pay in Gas Inventory Charges to assure that homes and schools are heated in the winter?

Answer:

Yes. The issues raised by your question relate to the comparability of firm transportation services that are offered by pipelines under their firm transportation rate schedules and firm transportation that is embedded in firm sales services. Access to upstream pipeline capacity and unbundled storage services, as well as other service comparability issues are among the most hotly contested issues in gas inventory charge (GIC) proceedings. The Commission believes, that, at a minimum, these issues must be addressed on a case by case basis in the various GIC proceedings.

The Commission recognizes that the development of competitive markets for natural gas depends, in part, on local distribution companies and direct sales customers gaining meaningful access to pipeline capacity so they can contract directly for competitively priced gas supplies. In so doing, the Commission requires open access pipelines to permit their firm sales customers the opportunity to convert sales entitlements to firm transportation entitlements over a five year period unless the parties agree otherwise. In Order No. 500, the Commission enacted a policy that permits pipelines to implement GIC's to recover future take-or-pay costs on a current basis. However, as a condition for implementing a GIC, the Commission required pipelines to grant their customers 100% conversion rights before the GIC is imposed so they would have an opportunity to contract directly for competitively priced gas supplies and, thereby, avoid the pipeline's GIC charge.

In each of the GIC proceedings the Commission has addressed, comparability of firm transportation services has been a major issue. This is true whether the proposal involved a cost-based or a market-based charge. For example, the Commission approved a capacity assignment program for Texas Eastern Transmission Corporation (Texas Eastern) whereby pipeline customers of Texas Eastern, including CNG Transmission Corporation and Algonquin Gas Transmission Company, are permitted to assign any firm transportation rights they hold on Texas Eastern to their LDC and direct sales customers. These downstream customers were accorded equal access to Texas Eastern's capacity along with its other firm sales customers. The Commission found that without the right to directly assign capacity, customers of the downstream pipelines would be foreclosed from meaningful access to competitive supply alternatives. Similarly, the Commission, approved a comprehensive settlement for Columbia Gas Transmission Corporation (Columbia) and Columbia Gulf Transmission Company (Columbia Gulf) that includes a GIC and a proposal to permit Columbia to directly assign to its wholesale customers a portion of its firm transportation right in Columbia Gulf to enable them direct access to natural gas supplies from the Gulf of Mexico.

Regarding contact storage, the Commission ruled in Order Nos. 436 and 500 that an open access pipeline company must provide access to its system storage capacity on a non-discriminatory basis. Contract storage, on the other hand, was exempted from that requirement primarily due to the nature of the private contracts involved. The Commission, however, has recognized the need for contract storage and other load equation devices, particularly in GIC proceedings, to facilitate the transition from reliance on pipelines as merchants to providers of transportation services. Unbundled storage services will increase the comparability of firm transportation and firm sales services, and, therefore, will lead to increased alternatives for pipeline customers and ultimately to efficient and competitive markets. In the GIC proceedings presently pending before the Commission, the parties to the proceedings have been directed to explore whether contract storage services are appropriate or necessary to ensure comparability of firm services.

Recently the Commission authorized ANR Pipeline Company to begin providing open access contract storage services. This was the first blanket storage service certificate issued. Several other proposals to provide open access contract storage services are now pending before the Commission. These types of load equation services should help pipeline customers to more efficiently contract and manage gas supply portfolios to meet their individual needs.

Question 4: What have been the general comments of local distribution customers and state utility commissions so far on FERC's "GIC" policy?

What problems have these groups identified for gas consumers?

Answer:

In their comments on the Commission's Notice of Proposed Policy Statement with respect to interim gas inventory charges, the local distribution companies and state utility commissions in general supported GICs. Some, however, saw no need for GICs in today's environment of reformed contracts and alternatives to inventory costs (e.g., storage and short term purchases). Most supported the deficiency based, WACOG method, coupled with a price ceiling on the commodity charge, over the demand based, competitive price method on the belief that the latter is not cost-based. They supported proposed conditions such as standby service, the 100 percent right to convert from sales to transportation service, storage rights for third party gas, and receipt point flexibility for deliveries into the pipeline system of gas purchased from sources other than the pipeline. Several stated that properly fashioned GICs should develop firm supply markets and prevent a repeat of the take-or-pay problems of the past.

A few raised concerns that GICs may lead to volatile prices, force pipelines to amend their contracts with customers, send incorrect market signals, and disadvantage local distribution companies in competing with pipelines for customers.

Question 5A: Has FERC staff completed any detailed studies to assure us that costs to residential consumers will in fact go down due to additional transportation on the pipelines? If so, please provide my staff with copies.

Answer:

The FERC staff has not completed any detailed studies regarding the affect of the Rate Design Policy Statement on residential consumers. With respect to rates for residential service, the FERC's jurisdiction impacts only the rates charged local distribution companies. The local distribution companies serve the residential consumers' requirements and are regulated by state agencies. The Policy Statement does, however, require the participants, including our own staff, to consider the impact of our guidelines and the various rate design proposals on the various classes of customers. Impacts on individual customer classes will be considered in the individual rate proceedings and will therefore be available to the Commission.

Question 5B: Aren't a number of major pipeline's that serve the Northeast, such as Transco and Tennessee, operating at nearly full capacity every day for most of the year, so that the new Rate Design Policy cannot encourage additional gas throughput? Doesn't this situation merely heap more costs on residential consumers without giving them any offsetting benefits?

Answer:

The Energy Information Administration published in August, 1989, an "Assessment of Pipeline Capacity to Transport Domestic Natural Gas Supplies to the Northeast". EIA concludes that the five major pipelines supplying the Northeast operate essentially at 100 percent of capacity on peak days. However, the average annual utilization rate into Pennsylvania, where most of the major underground storage facilities are located, is approximately 79 percent; and from Pennsylvania to the market areas of New York, New Jersey, and New England, the average annual utilization rate is approximately 50 percent.

Pipelines and the others serving the Northeast and other areas may be encouraged by the new Rate Design Policy to increase throughput. The result can be lower prices for the pipelines' customers which can be translated into lower rates for residential consumers at the state level.

To the extent a pipeline, or a particular segment of a pipeline, is operating at nearly full capacity most of the year it means that no significant additional through put can be realized and that the current rate design methods may efficiently achieve the goal of maximizing throughput during peak and off-peak periods.

Even if existing pipelines are operating at full capacity, implementation of the Rate Design Policy Statement principles should provide an additional incentive for the construction of new pipeline capacity. The Policy Statement sends an important signal to those who would utilize or construct new pipelines: the market -- not the Commission-- should dictate when and how much new capacity is desired.

Question 5(C): In a related matter, FERC's new Rate Design Policy loads more costs on "customers who value gas service the most." To me, this class of customers means residential consumers who must heat their homes during peak winter demand periods. FERC's policy statement justifies this cost shift by concluding that all customers, including residential, will benefit from increased amounts of gas being transported on the pipelines, thus spreading the fixed costs over more units of gas.

Isn't FERC's rationale that all classes of customers will benefit from increased throughput essentially the same argument condemned by the Court of Appeals in ruling that FERC's special marketing programs were unduly discriminatory against residential consumers?

Answer:

The Court of Appeals rejected the argument that increased throughput will benefit all classes of customers in the context of programs that excluded a class of customers from the programs. The Commission's new rate design policy statement does not exclude any class of customers from any programs. For example, a pipeline can offer discount rates to local distribution companies and those companies can participant in any capacity assignment (e.g., brokering of capacity) programs. In addition, the Court of Appeals in Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987) recognized that discounting in open access transportation is not in violation of its decision rejecting the increased throughput argument in Maryland Peoples Counsel v. FERC 761 F.2d 780 (D.C. Cir. 1985) because the captive customers had equal access under the open access transportation program. Last, the rate design policy statement expressly requires that the administrative law judges must consider and articulate the impacts (benefits and detriments) of the various rate design proposals on the participants, various segments of the industry, and on classes of customers and explicitly articulate equitable factors in designing rates. Hence, pragmatic adjustments can be made to mitigate harsh or undesirable results associated with a particular rate design method.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

OFFICE OF THE COMMISSIONER

October 10, 1989

The Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
Development and Production
Committee on Energy and Natural
Resources
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed please find a copy of my answers to the posthearing questions about the subject matter of the Oversight Hearings on Gas Inventory Charges. I have also sent, under separate cover, a complete set of my responses to each Senator who submitted posthearing questions.

Also, please find a corrected copy of my prepared testimony.

Yours truly,

Charles G. Stalon

Charles G. Stalon
Commissioner

Enclosures: 2

cc: Honorable Wendell Ford
Honorable Don Nickles
Honorable Pete Domenici
Honorable Malcolm Wallop

ANSWERS OF COMMISSIONER CHARLES G. STALON TO QUESTIONS FOR THE RECORD

QUESTIONS FOR THE RECORD FROM SENATOR BINGAMAN

Question 1(a): Attached is an analysis performed by the Energy Information Administration of the Department of Energy which compares natural gas spot market prices with the weighted average cost of gas for 20 major interstate natural gas pipelines. It has been asserted that this analysis demonstrates the impact that the Commission's proposed policy on gas inventory charges would have on producers.

(a) Does the EIA analysis present an accurate depiction of the likely impact that the Commission's proposed GIC policy would have on producers? Please explain your answer.

Answer: 1(a). I approve the Chairman's answers and add the following:

The pipeline company merchant is providing a service which merchants of spot gas are not. The pipeline company merchant is not merely selling gas, it is assuring its customers who hold contract demand rights on the pipeline that gas will be available whenever the customer so requests up to the amount of the contract demand. This is a valuable service. It is now being given away by the pipeline company merchant. The GIC is intended to price this valuable service.

Question 1(b): Has the Commission performed any independent analysis of the likely producing sector impact of its proposed GIC policy?

Answer: 1(b). I approve the Chairman's answers but add the following.

Columns A through H of Table 1Aa describe a nonsustainable circumstances. Pipeline company merchants without GICs cannot survive with gas prices 24 percent higher than that of their competition if competition among merchants is present. And pipeline company merchants in such circumstances are being pressured out of existence.

Whether a GIC that prices "firmness of service" will develop a 24 percent premium, or a 34 percent premium or a 14 percent premium is beyond my knowledge. My objective is not to reach a target price for firm (or spot) gas, but to create a pipeline transportation system that allows producers of gas and LDCs and end users to bargain into being market prices of gas.

QUESTIONS FOR THE RECORD FROM SENATOR FORD

Question 1: The Commission is to be commended for going as far as quickly as it has in crating the regulatory environment for establishing a procompetitive interstate pipeline transportation structure. However, it seems critical that the Commission complete that task by prompt resolution of a workable regulatory framework for the pipeline sales function to operate in the "open access" competitive transportation environment.

Are there remaining legal or policy impediments to prompt action on pipeline settlements which provide a resolution of the pipelines' sales function with their customers if the directly affected sales customers have agreed with the settlement proposal?

Answer: 1. I approve the Chairman's answer and add a personal view.

The Commission has an obligation to see that the rivalry between pipeline company merchants and nonjurisdiction merchants, and among pipeline company transporters is constructive, i.e., not predatory or otherwise inefficient. Consequently, as an example, the Commission must create pipeline transportation rate designs to accomplish that purpose. It must not let parties in a settlement subvert those objectives. Since a GIC is an essential element in allowing a pipeline company merchant to survive in a competitive natural gas industry, the Commission should not approve a settlement without a GIC.

Question 2. Has the Commission adopted an internal policy that would preclude interstate pipelines from being able to compete with others in the sales function on a comparable basis?

Answer. I endorse that part of the Chairman's answer which says: "The GIC is intended to be an efficient pricing structure for the pipeline merchant function which recognizes the increased supply option available to the pipeline's sales customers through open access transportation."

I add for emphasis, however, that although the Commission is on record approving GICs, it has been slow in developing a consensus on the type of GIC it should support. This slowness has left most pipeline company merchants in a competitively disadvantageous position.

Question 3: What are you going to do about the take-or-pay that accrues between March 31, 1989, the cutoff date for take-or-pay settlement recovery, and the time a company has its GIC approved by the Commission?

Answer: I accept the Chairman's answer.

QUESTIONS FROM SENATOR FORD (Cont'd)

Question 4: The Commission presumably intends that the GIC become incorporated into the pipeline's service obligation. But because the pipeline's obligation to serve continues beyond the life of the contract, doesn't that continued obligation conflict with the concept of a GIC as presented in Order No. 500?

Answer: I accept the Chairman's answer.

Question 5: Would basing a GIC on the natural gas spot market retard exploration and development through a back door reimposition of wellhead controls?

Answer: I accept the Chairman's answer.

Question 6: Have interstate pipelines generally exempted small general service customers from their proposed GICs?

Answer: I accept the Chairman's answer.

Question 7: Do you know of any pipelines that have not exempted small general service customers from the proposed GIC?

Answer: I accept the Chairman's answer.

Question 8: Has the Commission considered exempting small general services customers from the GIC?

Answer: I accept the Chairman's answer.

QUESTIONS FOR THE RECORD FROM SENATOR NICKLES

Question No. 1: At its February 15, 1989 meeting, the Commission considered a draft order regarding Transco's gas inventory charge (GIC), which held the spot market price to be the just and reasonable amount pursuant to section 601 of the NGPA. At the time the draft order was made available by the Commission for public review. Accordingly, please provide the Subcommittee with a copy of that draft order.

Answer: I have nothing to add to the Chairman's response.

Question No. 2: Many producers are concerned that the Commission's proposed spot market GIC (the so-called "competitive price concept") will put a great deal of pressure on pipelines to reduce the amount they pay producers for natural gas, or even to abrogate wellhead purchase contracts altogether -- particularly if the spot market GIC is deemed or held by the Commission to be the just and reasonable amount. Do you share any of these concerns What would be the consequences to domestic production and producers, particularly independents, if that were to occur?

Answer: I accept the Chairman's answer.

Question No. 3: Do you believe that the Commission has the authority to deny the passthrough of amounts actually paid to producers for deregulated natural gas under the NGPA section 601 just and reasonable standard (but for fraud, abuse or similar grounds) in light of the explicit and unambiguous meaning of that provision?

Answer: I accept the Chairman's answer.

Question No. 4: The "inventory charge" element of both proposed GIC alternatives does not appear to bear any relationship to the cost of maintaining supply. Is there any thing in the NOPPS which requires a pipeline to use the GIC supply security premium to maintain an inventory of gas? Is there anything in the NOPPS which requires a pipeline to ensure that an appropriate share of such amounts flow to smaller producers who have relatively less market power than major producers?

Answer: I accept the Chairman's answer but add the following:

At some time in the future, probably soon, the market will develop a price for "firmness" as non-jurisdictional; gas merchants offer firm service. Pipeline company merchants will be required to match or beat that price or fade out of the business of providing firm gas service. The cost of service priced by GICs will be required to adjust to the market determined GICs rather than the GIC adjust to the pipeline company merchant's cost.

QUESTIONS FROM SENATOR NICKLES (Cont'd)

If the FERC is successful in separating pipeline company merchant and transportation functions and allowing competition to intensify in natural gas markets, the market will set prices, and merchants, including pipeline company merchants, will determine what role to play given that each has no control over prices.

If this competitive future unfolds as expected, and the nation is almost there now, it will be necessary to reconsider the zero profit constraints the FERC now imposes on pipeline company merchants. My tentative view is that pipeline company merchants cannot survive the zero profit constraints without receiving cross subsidies from the earnings on transportation, storage and gathering assets. However, such cross subsidies induce inefficiencies in rivalry among pipeline companies as transporters and ought to be avoided like the plague. It logically follows, therefore, that efficiency in competition in gas markets and efficiency in rivalry among regulated transporters would be furthered if the natural gas merchant activities of pipeline companies were transferred to nonjurisdictional merchants, which includes pipeline company marketing and producing affiliates, and transporters are required, to treat all merchants alike.

Question 5(a): One of the fundamental defects of the proposed spot-market GIC is that it ties the price of pipeline gas sales to an artificial index. That index now is below most pipelines' WACOG, because of the softness in the gas market.

(a) If the market tightens, wouldn't the Commission's spot market GIC then result in above-market and above WACOG prices set for the GIC? What would happen then? What are the implications for consumers?

Answer: I endorse the Chairman's answer.

Question 5(b): If the GIC is below WACOG wouldn't pipelines get "stuck" with the difference between that which they paid for gas and that which they sold it for? What are the implications of that for pipelines and producers?

Answer: I endorse the Chairman's answer.

Question 5(c): What would be the basis for the Commission's defense that the methodology for calculating the spot market GIC is not arbitrary or capricious?

Answer: I accept the Chairman's answer but call attention to my elaboration in response to question (4).

QUESTIONS FROM SENATOR NICKLES (Cont'd)

Question No. 6(a): The Commission's NOPPS outline two alternative formulations for GICs.

(a) Have the commentors on the NOPPS proposed any alternative formulations for a GIC?

Answer: I accept the Chairman's answer.

Question No. 6(b): With respect to the proposed "competitive price concept," is it necessary to tie the GIC to a spot market index?

Answer: I accept the Chairman's answer.

Question 7: Under the NOPPS reconciliation mechanism, a pipeline need not refund over-collections to its customers; it can instead use those monies for: 1) premiums to producers; 2) take or pay buy-out/buy-down settlement payments; 3) contracts reformation costs; and 4) carrying charges on gas prepayments. (NOPPS; p.21)

The NOPPS is silent on the question of when, by what means, and for what reasons can parties challenge the uses of GIC overcollections. What are your views?

Answer: I accept the Chairman's answers.

Question 8: In the NOPPS the Commission indicates that pipelines seeking to utilize interim GICs must offer their customers firm transportation service to the extent they nominate less than their firm sales entitlements. The NOPPS explained that, in this manner, pipeline customers would not be totally captive to the pipeline's sales service and that this fact of competition should impose discipline on the pipeline with respect to its gas purchasing practices.

Is it the case that an effectively functioning GIC requires a pipeline's customers to have the option to convert their sales entitlements to firm transportation and thereby have access to alternative supply options?

Answer: I accept the Chairman's answer.

Question 9: The Commission has been apprised by many diverse elements of the natural gas industry of the problems created by the present policy of attaching pregranted abandonment to firm transportation service that is created by a pipeline customer's conversion of this firm sales entitlement. As the Natural Gas Supply Association - the producer association whose members account for 90% of the natural gas produced in the United

States - commented recently, the new competitive market environment that envision for the natural gas industry cannot arise as long as there remains such a dramatic difference in the reliability of CD sales and firm transportation that the pipeline's LDC customers are not able to convert and, thereby, risk the possibility that their firm transportation capacity might be lost.

Given the importance of meaningful CD conversion rights to the establishment of just and reasonable GIC mechanisms, is it possible to establish any GIC - either interim or permanent - without resolving the pregranted abandonment issue first?

Answer: I must differ with the Chairman's answer in two respects. Before doing so I should record my agreement with the producer association statement paraphrased in the question, namely

> "...the new competitive market environment that [the FERC] envision[s] for the natural gas market cannot arise as long as there remains such a dramatic difference in the reliability of CD sales and firm transportation...."

The Chairman's first sentence is technically correct: "The issue may be dealt with through negotiation or in a GIC proceeding." But it is also important to recognize that it could be dealt with in the Final Rule of Order No. 500. Order No. 500 repromulgated Order No. 436 in an interim basis. The final rule could promulgate rules that insure that firm sales service and firm transportation will have the same degree of reliability.

To leave the matter to "negotiation" is to leave the customer at the mercy of the monopoly power that the FERC is charged with disciplining. To leave it to GIC proceedings is to leave it to negotiation and/or to tolerate diverse outcomes among pipeline companies, including the possibility that some will perpetuate the existing system of unequal services.

One simple way to remedy this problem, a way which I thought, until recently, the Commission had endorsed when it adopted Order No. 436, is merely to assert that a holder of firm transportation rights is always first in the queue for the amount of capacity previously held when that holder's transportation contract expires.

QUESTIONS FOR THE RECORD FROM SENATOR DOMENICI

Question 1(a): It appears that the proposed spot market gas inventory charge (GIC) adversely affects both producers and consumers.

(a) Would you agree that the spot market GIC ("competitive price concept") -- even if the Commission does not deem it to be just and reasonable -- would put a great deal of pressure on pipelines to push wellhead prices down towards the spot price?

Answer: I accept the Chairman's answer.

Question 1(b): If the spot market GIC is deemed to be just and reasonable, would you agree that that would virtually guarantee that wellhead prices would fall to the spot price?

Answer: I accept the Chairman's answer.

Question 1(c): If the spot market GIC results in reduced exploration, would you agree that consumers would be adversely affected over the long run by reduced supply and increased prices, even though they may benefit somewhat from lower prices in the short run?

Answer: I accept the Chairman's answer.

Question 1(d): Would you agree that it would be possible to design a GIC which instead simultaneously benefits consumers and all segments of the natural gas industry?

Answer: I accept the Chairman's answer, especially the first sentence. As to the second sentence, I have some doubts. I am tentatively convinced that only a competitive price GIC can serve the purposes of furthering efficient competition in gas markets and efficient rivalry among regulated pipeline transporters.

Question 2: During the 1960s and 1970s the Commission kept the wellhead price of natural gas artificially low, and that led to shortages in the interstate marketplace. Those growing gas shortages -- culminating with the severe shortage during the winter of 1976-77 which closed schools and businesses in the Midwest -- led to the enactment of the Natural Gas Policy Act of 1978.

The NGPA recognized and did away with the problems of having a dual market and interfering with wellhead prices, although for political reasons not all natural gas was to be deregulated pursuant to it. Congress only recently finished the job begun by the NGPA, and has now set a timetable for total wellhead decontrol.

QUESTIONS FROM SENATOR DOMENICI (Cont'd)

It would appear, however, that the Commission is proposing to turn back the clock by artificially suppressing the wellhead price of natural gas in interstate commerce, albeit through a new regulatory mechanism -- the spot market GIC.

Do you think that the consequences of artificially interfering in wellhead pricing -- assuming that such actin is lawful -- would result in any better outcome now than it did in the 1960s and 1970s?

Answer: I accept the Chairman's answer.

Question 3(a): Section 601 of the NGPA provides for the automatic passthrough by pipelines of amounts paid for the purchase of natural gas. As a matter of law, do you believe that the spot market GIC, or any amount which is other than that which a pipeline actually pays for gas (be it higher or lower), can be deemed to be just and reasonable without violating the spirit and letter of section 601?

Answer: I accept the Chairman's answer.

Question 3(b): If you believe that the Commission has the authority to hold as just and reasonable amounts other than that which a pipeline actually pays (absent fraud, abuse or other similar grounds), please provide the Subcommittee with a full legal analysis supporting that view.

Answer: I accept the Chairman's answer.

Question 3(c): It is my understanding that the Commission's February draft order regarding Transco's GIC, which was made available for public viewing on the day of the Commission's February 15, 1989 meeting, held the spot market price to be just and reasonable. Because it was made available to the public at that time, please provide the Subcommittee with a copy of that draft order.

Answer: No answer needed by me.

Question 4(a): Assume for the purpose of analysis that notwithstanding the clear meaning of section 601 of the NGPA, the Commission somehow found the authority to deny the passthrough of gas purchase amounts above some Commission-established level -- say spot market prices -- as not being just and reasonable.

(a) As a practical matter wouldn't that mean that notwithstanding the recent Congressional elimination of wellhead price controls, the Commission could reimpose wellhead price controls, albeit indirectly?

QUESTIONS FROM SENATOR DOMENICI (Cont'd)

Answer: I accept the Chairman's answer.

Question 4(b): Wouldn't that action give pipelines a legal basis to assert *force majeure*, or exercise FERC out and market-out clauses, or other similar provisions in their contracts with producers, notwithstanding the statement in the NOPPS that the proposed GICs "are in no way intended to affect contractual rights and responsibilities arising under any pipeline's gas purchase contracts"?

Answer: I accept the Chairman's answer.

Question 5: The Energy Information Administration of the Department of Energy has provided me an initial impact assessment of the proposed spot market GIC. That analysis shows that had the spot market GIC been in place last year and prices ramped down to spot levels, the producers who well to the 20 largest pipelines would have lost $1.3 billion last year and $842 million during the first six months of this year. Copy attached.

Has the Commission itself analyzed the impact of the two alternative proposed GICs on wellhead prices, exploration, reserves and production? If yes, please provide the Subcommittee a copy of the analysis.

Answer: No answer required of me.

Question 6(a): In addition to the policy problems which would be caused by the use of the spot market GIC, the methodology proposed for its calculation also appears to be seriously flawed. On page 7 of the NOPPS the Commission asserts that the competitive price composite of the spot market GIC represents a "true" market price and not a presumed market price. Does the Commission's methodology reflect a pipeline's "true" cost of acquiring gas, or does it instead only create a "presumed" cost of acquiring gas which bears no relationship to a pipeline's WACOG?

Answer: I accept the Chairman's answer but add the following:

No one knows the cost of providing "firmness of gas service," just as no one knows the cost of providing "firmness of transportation service." Over decades, certain conventions have developed for manipulating original cost measures into annual revenue requirement measures. Other conventions have also developed for transforming these annual revenue requirements into prices from transportation services. No one with sophistication in economic regulation takes such transportation prices as estimates of unit costs of the services provided. Such a system of conventional pricing depends heavily on the existence of pipeline monopoly power. To the extent that the monopoly power is reduced, the pricing discretion of regulators is also reduced; market forces will place limits on prices. If the monopoly power is eliminated entirely, then pricing discretion is reduced to trivial dimensions, and markets forces will determine prices. What is true of pipeline transportation pricing is even more true with gas pricing. Although the FERC has attempted to find a plausible cost justification for GICs, as it attempted to find a plausible cost justification for gas prices in the 1960s and 1970s, the relevant force at work, and increasingly so, is the market. As these market forces strengthen, the FERC will be required to accept GICs as determined by the market no matter what the created cost figures show.

The principal lesson of the 1970s is that efficient natural gas prices are not determined by average cost, either embedded or current, they are market determined. One can argue, and I did so in my prepared testimony, that such prices tend to approximate the marginal social cost of producing the services, but that approximation is best thought of an average relationships over time. The marginal social cost does not determine the price of gas. Prices are determined by interaction of demand and supply forces, not by one of those forces.

I conclude from these remarks that one should not take seriously the FERC attempts to estimate the unit cost of GICs. The important issues is not finding a cost base for GICs but developing market forces that will define market based GICs.

Question 6(b): Is it true that the prices used in the spot market GIC calculations are not weighted by volume?

Answer: I accept the Chairman's answer.

Question 6(c): Would the use of unaudited and unverified data provided by pipelines to trade publications present any potential or incentives for abuse? Has the Commission itself verified that the prices reported to these trade publications are correct?

Answer: I accept the Chairman's answer.

Question 6(d): Does FERC plan on auditing the published data to ensure that it continues to be provided accurately by the pipelines to the trade publication, and published accurately by the trade publications? If not, should the Energy Information Administration be directed to collect and publish the necessary data?

QUESTIONS FROM SENATOR DOMENICI (Cont'd)

Answer: I accept the Chairman's answer.

Question 7: I understand that the Commission's policy has been to permit GICs only if it can be shown that "sufficient" competition exists in the pipeline's sales market. Can there be "sufficient" competition if pipeline firm transportation services are not comparable in quality to their sales service? Are they now comparable? Do you believe that a necessary precondition of any interim or permanent GIC is that firm transportation service of a pipeline must be fully comparable to its sales service?

Answer: I accept the Chairman's answer, but would repeat a statement from page 26 of my prepared testimony.

> An issue often posed for regulators is whether competition is sufficiently intense to allow discretion in pricing to a regulated firm. A superior question, and one especially relevant in the GIC rate design, is whether the discretion will intensify or limit competition. Earlier it was argued that deficiency-based GICs limit competition by encouraging other merchants to adopt deficiency-based GICs. In contrast, a competitive-price GIC will intensify competition by encouraging other pipeline companies which are prevented from imposing deficiency-based GICs and nonregulated merchants to adopt competitive-price GICs. Rivalry will, therefore, lead to a market determination of the charge necessary to pay for the security of supply or "firmness of service" demanded by gas buyers.
>
> The determination of the proper firmness-related GIC charge must await the development of a market for different degrees of firmness of service. I would approve almost any such charge and commodity price, or any set of such charges, if a pipeline company merchant wants to offer two or more grades of service (footnote omitted) (provided customers are free to abandon the pipeline company merchant for other merchants and free to reduce their CDs). The benefits of creating competition in this dimension of the market are worth the risk of some minor mispricing of grades of service.

Question 8: FERC Order No. 500 has been an "interim" order for such a long time it can, for all practical purposes, be called a "final" order. Is this what we can expect to happen if the Commission implements "interim" GICs?

Answer: I accept the Chairman's answer, but would repeat a statement from page 27 of my prepared testimony.

QUESTIONS FROM SENATOR DOMENICI (Cont'd)

Furthermore, I do not see the necessity of interim GICs. If only competitive-price GICs are to be accepted, I would accept permanent GICs now (provided again, that current customers are free to cease buying from the pipeline company merchants and free to reduce their CDs). I would reserve, however, the right for the FERC to review its cost-allocation practices so that both pipeline companies and their transportation and sales customers are on notice that transportation costs may rise or fall as the result of such a review.

Question 9(a): The Illinois Commerce Commission stated in its comments to FERC that the proposed:

> . . . reconciliation procedure, when combined with a demand-based IGIC, creates the opportunity for pipelines to severely harm the competitiveness of the spot market. It does so by providing pipelines with a costless opportunity to subvert the spot market with their customers' dollars. The proposed demand-based charges (based on the spot price of gas, the pipeline;s rate of return, and a required gas take percentage) and the commodity price (limited to the spot price) will be very similar across pipelines. However, the incurred cost, based on each pipeline's portfolio of contracts and take-or-pay charges, may differ substantially. Pipelines which anticipate that their revenues under the IGIC would exceed their incurred costs under this procedure, could costlessly meet the spot market with superior firm service and force their spot supply competitors from the market.
>
> The ICC does not believe that the FERC should encourage pipelines to employ an IGIC to enable them to regain monopoly control over the spot market. To do so would be to reverse the enlightened FERC policies which have permitted a competitive spot market to flourish. The potential harm to the competitiveness of the spot market makes the demand-based IGIC unacceptable. Therefore the ICC believes that the demand-based IGIC proposal should be withdrawn from the final policy statement.
> (ICC comments, pp 2-3)

(a) Is the Illinois Commerce Commission right? Could a pipeline use GIC over-collections to make system supply gas super-competitive with spot-market gas? What impact would that have on the spot market price for gas? Would that create an "unlevel playing field"?

Answer: I accept the Chairman's answer.

QUESTIONS FROM SENATOR DOMENICI (Cont'd)

Question 9(b): It would appear that the proposed reconciliation mechanism would give pipelines an interest free loan for up to two years. Is that intended, and is that good policy?

Answer: I accept the Chairman's answer.

Question 10(a): In the recent Panhandle case (Docket No. RP89-185-000) the Commission approved a spot market GIC without any of the projections of the proposed spot market GIC: it allowed the customers of the pipeline to agree to buy a minimum quantity from the pipeline rather than from the pipeline's competitors, and did not require the pipeline to allow customers to nominate volumes freely. Is that anticompetitive or inconsistent with the Commission's open access transportation program?

Answer: I accept the Chairman's answer.

Question 10(b): Is it inconsistent with the policy intent of the NOPPS?

Answer: I accept the Chairman's answer.

Question 10(c): Is it inconsistent with the Commission's policy embodied in Order No. 380?

Answer: I accept the Chairman's answer.

Question 10(d): Did this decision help or hurt producers who sell to Panhandle, and competition generally?

Answer: I accept the Chairman's answer.

Response to Senator Domenici's question
to
Commissioner Stalon

Question

In your opinion, are there any actions which the Commission has taken, or failed to take, which has impeded the movement of natural gas out of New Mexico? What steps could the Commission now take to encourage gas movement out of New Mexico?

Answer

The gas reserves in the San Juan basin enjoy a locational advantage for the California markets relative to midcontinent, overthrust, Permian or gulf coast regions. Because of this, these reserves were contracted by, and received FPC dedication to the pipelines serving California. In the pre-NGPA regulatory regime, there was no need for reserves to have access to multiple pipelines, and in fact such multiple access was generally considered duplicative and wasteful. The physical pipeline assets in place serving the San Juan basin today are remnants of that earlier time. As a consequence, under "standard" forward-haul transportation, these reserves are limited to compete in the California markets. All New Mexico gas entering that market must pass through the pipes of one of two large distribution companies.

As you know, the natural gas industry is both creative and flexible. A wide variety of "non-standard" efficiency-generating transactions are often used by pipelines and others to reduce costs, free-up capacity or arbitrage regional price disparities. Among these are exchanges and back-hauls. When the regulatory and economic factors are conducive, the competitive market has shown well its zeal to realize these gains. The Commission's stated policy, which we have not yet fully implemented, is to create conditions which facilitate these efficiency gains. Back-haul rates and associated conditions of service is an area which is not fully implemented and which likely would benefit San Juan production.

In general, from a cost causation perspective, back-haul rates should either be zero or negative. Relative to forward-hauls, back-hauls free-up pipeline capacity and have negative fuel use for compression. Under rates approved prior to our Rate Design Policy Statement (Docket No. PL89-002-000), back-haul rates could never be negative, and except for individually certificated exchanges, could not be zero. Accordingly, moving San Juan gas to non-California markets, which would require a back-haul or exchange, could only be done by paying higher-than-required rates. These high rates, of course, has a chilling effect on the netbacks and attractiveness of non-California

RESPONSE TO SENATOR DOMENICI'S QUESTION TO COMMISSIONER STALON (Cont'd)

markets to San Juan producers. It is my hope that the Commission will fulfill its newly-stated policy and create efficient back-haul and exchange rates, which will more fully and efficiently integrate producers with markets.

QUESTIONS FOR THE RECORD FROM SENATOR WALLOP

Question 1: I understand that Kern River recently filed with the FERC an application for an Optional Expedited Certificate. What is the status of this application before the Commission?

Question 2: What is the procedural process through which the application must go before it can be approved?

Question 3: How long should this process take?

Answer: I have nothing to add to the Chairman's answers.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

October 25, 1989

Senator Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
  Development and Production
Committee on Natural Resources
United States Senate
Dirksen Senate Office Building - Room 364
Washington, D.C.   20510-6150

Dear Senator Bingaman:

Enclosed please find my answers to the Gas Inventory Charge post-hearing questions posed by Senator Metzenbaum. I have coordinated my answers to the answers given by Chairman Hesse. If you have any further questions, please do noT hesitate to contact me. Thank you.

Sincerely,
Charles G. Stalon
Charles G. Stalon
Commissioner

Answers of

Commissioner Charles G. Stalon

to

Senator Metzenbaum's

Gas Inventory Charge
Post-hearing Questions

Question 1. FERC's Gas Inventory Charge Policy Statement contemplates that "GICs" are implemented as add-on charges from pipelines to consumers so as to secure long term gas supplies, and to pay for any new take-or-pay problems between pipelines and producers. Under FERC's Order 500 take-or-pay bailout of pipelines and producers, FERC allowed automatic passthrough of up to 50 percent of past take-or-pay liabilities directly to consumers.

Under the "GIC" policy, residential and other captive consumers, who must rely on pipelines' system supplies of gas, are essentially paying for 100 percent of pipelines' future take-or-pay liabilities. Why is this fair?

Answer. I would qualify the Chairman's answer in two respects:

First, I would change the last sentence to read: "Under a **competitive-price** GIC, sales customers would pay those costs on a current basis." I do not believe that one can persuasively make a similar assertion about a deficiency-based GIC. A deficiency based GIC will produce a payment pattern from LDCs to pipelines and from pipelines to producers very similar to the pattern that existed in the past, that is, there will be no GIC payments when a pipeline forecasts gas demand correctly or when demand exceeds forecasts, but when demand is significantly below forecasts large GIC payments must be expected. I would not characterize such a payment pattern as one which pays for gas "on a current basis."

Second, I would emphasize that there are two types of gas service available, firm and spot. The gas inventory charge, properly designed, is a payment for "firmness." To the extent that a pipeline's customers are willing to depend on spot gas, they can avoid a gas inventory charge. On the other hand, to the extent they want contractual assurances that gas will be available from the pipeline when they ask for it, that is, that they want firm gas service, a "firmness charge" is necessary to compensate the pipeline company merchant for its cost of purchasing "firmness."

I would argue that a gas inventory charge is necessary to increase both the efficiency and fairness of natural gas markets.

With two types of gas service, customers of pipeline company merchants are free to select the mix of the two services each desires. Furthermore, the price of each service should, with a properly designed GIC, reflect the cost incurred by the gas merchant who provides the service(s). The prices of non-jurisdictional gas merchants will be disciplined by market forces, and the prices of jurisdictional merchants, i.e., pipeline company merchants, will be disciplined by regulation. My prepared testimony makes clear that, in my view, a competitive-price GIC can serve to improve both the efficiency and fairness of natural gas markets. That testimony also emphasized, however, that a deficiency-based GIC is not likely to produce such results.

In contemplating the significance of this argument, it is important to recognize that gas inventory charges are made necessary by increasing competition among gas merchants. In the presence of that competition, if a pipeline company is to remain in the gas merchant business of selling firm gas service, in contrast to the gas transportation business, it must have a GIC. If a GIC is denied the pipeline, it must be expected that it will, as soon as it can, withdraw from the gas merchant business. While such a withdrawal might serve to enhance competition in the natural gas business by withdrawing merchants that are now dominant in the business, it must also be recognized that there are some customers of pipeline company merchants who want them to stay in business. Since I find it impossible with my current level of knowledge to assert with confidence whether the industry will better serve gas end users with pipeline companies as gas merchants that without such merchants, it logically follows that a fair test is needed. A fair test will is one in which those merchants who best serve gas end users will survive and those who do not serve end users as well will fail. A fair test requires that pipeline companies be allowed and encouraged to implement competitive-price GICs.

Question 2. How is FERC's deficiency-based "GIC" so different from the "minimum commodity bills" that were outlawed by FERC in Order 380 and found by the Court of Appeals to be anti-competitive limitations on customers' ability to shop for the cheapest supplies?

Answer. I believe that deficiency-based GICs are much too similar in their effects to minimum bills to be tolerated. For this and for other reasons stated in my prepared testimony, I have not supported deficiency-based GICs. In all my arguments favoring GICs, I have tried to make it explicit that it was competitive-price GICs that I support.

Question 3. In Ohio, and many other consuming states, residential consumers buy their gas from local distribution companies who buy gas from their pipeline suppliers. These pipeline suppliers, such as Columbia and Consolidated, in turn get their gas through pipelines upstream of them that ultimately connect to producing areas. FERC's open access transportation policy contemplates that local distribution companies can get the best mix of lowest cost and secure gas supplies for their customers by shopping for gas. Customers can, in theory, now buy spot market gas supplies, and long term, firm supplies directly from producers, from pipeline suppliers, and gas marketers or brokers. Yet Ohio local distribution companies who want to buy a mix of low cost spot market gas and long term firm supplies directly from producers are not always able to get firm open access transportation from the producing areas through the upstream pipelines. In other words, if East Ohio Gas wanted to buy a large, long term secure supply of gas from a producer, it may not be able to bring the gas to Ohio consumers even though Consolidated, its direct pipeline supplier and an open access transporter, was paying its upstream pipeline suppliers demand charges for space on their pipelines extending to the producing areas. Other restrictions prevent gas utilities from using as purchased directly from producers to be injected into underground storage systems near the consuming areas for customers' use during peak winter periods. Some pipelines still require customers to buy higher cost pipeline-supplied gas if they want critical winter storage. Doesn't FERC have to fix these fundamental problems that prevent customers from shopping for a mix of least cost, secure supplies and unbundled cost-based storage and other services before those customers can decide how much they need to pay in Gas Inventory Charges to assure that homes and schools are heated in the Winter?

Answer. The Chairman's answer is a good one. I would add emphasis, however, to the importance of non-discriminatory transportation being available to all LDCs, and to other potential shippers. While the FERC has made a great deal of progress in inducing pipeline companies to grant transportation rights comparable to the transportation rights that are embedded in the pipeline company's merchant service, the effort has been insufficient in three important dimensions:

a. **Assignment of capacity.** Holders of pipeline firm capacity must be able to broker that capacity if the transportation market is to induce as efficient a use of pipeline capacity as pipeline managers were able to do when they possessed a monopoly over gas sales.

b. **Contract demand reductions.** Holders of pipeline capacity who do not want all the capacity they currently hold must be able to reduce their holdings. To insist that they continue to hold, and pay for holding, capacity they do not need while simultaneously denying them the right to assign such unwanted capacity is especially inefficient. That, however, is the policy the FERC has been implementing since the issuance of Order No. 500.

c. **Backhaul and exchange pricing.** Pipeline companies continually engage in efficiency improving backhauls and exchanges. The failure of the FERC to properly price these types of exchanges has made it difficult for competing merchants to gain these efficiencies. There are, however, reasons for optimism; in the FERC's policy statement on rate design there was an invitation to parties to recommend improvements in such pricing.

Question 4. What have been the general comments of local distribution customers and state utility commissions so far on FERC's "GIC" policy?

What problems have these groups identified for gas consumers?

Answer. I will accept the Chairman's answer to this question since the staff is in a much better position than I to conduct a thorough survey of such responses.

Question 5. In a related matter, FERC's new Rate Design Policy loads more costs on "customers who value gas service the most." To me, this class of customers means residential consumers who must heat their homes during peak winter demand periods. FERC's policy statement justifies this cost shift by concluding that all customers, including residential, will benefit from increased amounts of gas being transported on the pipelines, thus spreading the fixed costs over more units of gas.

Question 5.a. Has FERC staff completed any detailed studies to assure us that costs to residential consumers will in fact go down due to additional transportation on the pipelines? If so, please provide my staff with copies.

Answer. This question is only for the Chairman. No answer is needed from me.

Question 5.b. Aren't a number of major pipelines that serve the Northeast, such as Transco and Tennessee, operating at nearly full capacity every day for most of the year, so that the new Rate Design Policy cannot encourage additional gas throughput? Doesn't this situation merely heap more costs on residential consumers without giving them any offsetting benefits?

Answer. I must agree that if one pipeline with a given capacity is considered in isolation, and that pipeline is running full year round, then no rate design reform can increase throughput.

That, however, does not end the argument. Capacity can be expanded, and one of the objectives of rate design reform is to encourage efficient capacity expansion. If a) pipelines serving the Northeast are running full while some of those serving the Southeast and the Midwest are not, b) some of those pipelines which serve the Northeast also serve some customers who could be served by pipelines which principally serve the Southeast and/or Midwest, and c) rate design reforms encourage customers who have choices to leave the full pipeline(s) and take service from those which are not running full, then it would be possible to free-up some of the upstream capacity of the Northeast pipelines and allow the expansion of capacity only on the downstream segments where a bottleneck exists.

The looping required in such a case might be very small compared to the looping that would be required without such rate reform. If rate design reforms can induce such a result, some customers in the Northeast who could not get service formerly might now do so. While the amount of gas going through the upstream segments of the pipelines serving the Northeast would not increase, the capacity on the downstream segments serving the Northeast would increase, and at a lesser cost relative to the case where full looping is required. A scarce commodity (e.g., capacity to the Northeast) is produced more efficiently.

The result of such rate reforms, assuming the reallocation of capacity is as described, would be, under customary rate making models, a lower average price for customers on the pipelines that were formerly not fully utilized, and, if the incremental cost of capacity on the downstream segment of the Northeast pipeline is equal to the embedded cost of capacity, no change in the average price to customers on the Northeast pipelines.

It is likely that on-peak customers will experience price increases and off-peak ones will experience price decreases if the proposed rate design reforms are implemented, and it is also likely that most residential customers are on-peak customers. If one postulates that customers' welfare varies inversely with the price they pay for gas in the on-peak period, then one would have to conclude that pipeline rate reforms of the type described above, even though they increase pipelines' throughput, will lower customers' welfare. Customers as citizens, however, have interests broader than the price of gas in on-peak periods. They not only heat their homes, they buy and use many things made using gas, they consume electricity generated by gas in the summertime when they are running air conditioners, and they work in gas-using industries. Well reasoned economic arguments support the conclusion that increasing economic efficiencies in the use of gas will produce net benefits for consumers in general, although not necessarily for any particular subset of natural gas consumers.

Question 5.c. Isn't FERC's rational that all classes of customers will benefit from increased throughput essentially the same argument condemned by the Court of Appeals in ruling that FERC's special marketing programs were unduly discriminatory against residential consumers?

Answer. I do not recall that I have ever argued that pipeline rate design reform will benefit all classes of gas-using customers. I have certainly never argued that pipeline rate design reform will uniformly benefit all pipeline customers, gathering, transportation, storage, and sales. As a heuristic device I have argued that improvements in pipeline efficiency has the potential to benefit all classes. I have never, however, said that was the objective. As I stated in answer to Question 5.b, the welfare of citizens should not be assumed to vary inversely with the price paid solely for on-peak gas service. The benefits of an economically efficient pipeline transportation system will spread to many citizens who consume many different products.

A more precise answer to the question requires a definition of undue discrimination. As a first approximation to that definition, I would equate due discrimination with economically efficient pricing and undue discrimination with economically inefficient pricing. Leaving all the qualifications to those definitions aside, I must, therefore, conclude that, properly implemented, the FERC rate design reforms will not create unduly discriminatory prices. In fact, it is the current inefficient prices that arguably are unduly discriminatory.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

October 11, 1989

OFFICE OF THE COMMISSIONER

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
Development and Production
Committee on Energy and Natural
Resources
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman,

Enclosed are my responses to the post-hearing questions for the Subcommittee's September 14, 1989, oversight hearing on Gas Inventory Charges. Please contact me if you have any other questions or comments.

I would like to take this opportunity to reiterate the statement in my testimony about the critical importance of the Subcommittee's continued oversight on this very significant issue for all segments of the natural gas industry. As the September 14 hearing and subsequent hearings have demonstrated well, any proposal to force down all wellhead natural gas prices to spot market prices would be a crucial strategic mistake by the Commission and a devastating blow to the producing sector. The continued oversight efforts of the Subcommittee should serve to prevent that unacceptable result.

Thank you again for communicating your concerns to the Commission and scheduling the September 14 oversight hearing to review those concerns.

Sincerely,

Charles A. Trabandt

Charles A. Trabandt
Commissioner

Enclosure

ENCLOSURE

COMMISSIONER TRABANDT'S RESPONSES TO
QUESTIONS FOR THE RECORD FROM THE OVERSIGHT HEARING
OF SEPTEMBER 14, 1989,
ON GAS INVENTORY CHARGES
OF THE SUBCOMMITTEE ON
MINERAL RESOURCES DEVELOPMENT AND PRODUCTION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

I. Introduction

Chairman Hesse, by letter of October 10, 1989, has transmitted responses prepared by the Commission staff to the questions for the record. In the interests of brevity, I will comment briefly on those responses, cross-reference relevant discussion in my testimony, or add additional discussion.

II. Questions from Senator Bingaman

Question 1(a). This question requests that the Commission comment on the EIA analysis of the impact of spot market pricing prepared for Senator Domenici. The Commission staff answer argues that the EIA analysis is merely an "arithmetic exercise" comparing average spot market prices to the applicable pipeline Weighted-Average-Cost of Gas (WACOG), which ignores the availability of the Gas Inventory Charge adder or demand charge. Staff asserts that the additional revenues from the latter charge would support wellhead prices in excess of the spot market, thus approaching the WACOG.

I believe the staff has fundamentally mischaracterized the spot market GIC. As I testified, the spot market GIC is composed of a spot market price for purposes of establishing the base commodity charge and a second charge (or GIC charge) to provide revenues primarily for take or pay-related expenses. Those take or pay-related expenses would include prepayments, buyout and buydown costs, contract reformation costs, and probably gas future costs (as originally urged by the staff), all to offset the continued take or pay exposure of the pipelines which may occur as the transition to competitive gas markets evolves. The GIC portion of the spot market concept could only be used to support gas prices above the spot market price if, and only to the extent that, the GIC adder is not fully used for such take or pay-related costs. If all, or almost all, of the GIC adder is consumed to meet such other, take or pay-related costs, there will be very little, or none, of the adder-generated revenues to support current gas purchases from existing wellhead gas contracts. In all likelihood, as most observers now believe, the Chairman's spot market GIC proposal would have virtually no additional revenues above the spot market price to support current gas costs under existing contracts at today's WACOG. In fact, there would only be such remaining, significant levels of revenues above spot market prices if -- and only if -- there were no further buyouts, buydowns, contract reformations, prepayments and gas future costs to use the funds generated by the GIC adder. That, in turn, is only going to occur when existing contract prices approximate spot prices for an extended period of time and/or all existing contracts have already been renegotiated to include so-called "market responsive" pricing provisions.

As I testified at the hearing, the original intent of the spot market GIC was to drive or "ramp down" the current natural gas price at the wellhead (WACOG) under existing contracts (about $2.30 today nationwide) to spot market prices. The EIA analysis and study fairly and accurately demonstrates the inevitable results of that particular proposal and the devastating impact on the producing sector. The staff's discussion in the 1(a) answer, particularly the last paragraph, hints strongly that the price differential between the WACOG and spot prices is the problem that must be remedied in this proposal by eliminating the difference by some means. Just as clearly as 1+1=2, the same pot of GIC dollars cannot fund both the take or pay-related costs and the incremental wellhead gas purchase costs to get the price for producers from the spot market to the current WACOG. That's why the EIA analysis is much more than a mere "arithmetic exercise" --particularly for U.S. natural gas producers.

Question 1(b). This question asks if the Commission has performed any independent analysis of the likely producing sector impact of the proposed GIC policy (i.e., spot market GICs). Ironically, until this question was asked, the answer was categorically no, at least as far as the Members of the Commission were concerned. In fact, I have repeatedly asked since February of this year, when the spot market GIC was first proposed, whether the Commission staff had any analysis to support any conclusion other than that which I included in my testimony; i.e., rampdown to spot prices. Now comes this late blooming analysis modeled on the EIA analytical approach, but with one very fundamental and crucial difference.

As discussed in the preceding answer, the EIA analysis quite properly assumed that the revenues from GIC adder would not be available for non-take or pay-related costs (such as well-head prices above the spot market price), because those revenues would be consumed to fund take or pay-related costs. Most commentors would agree that all of those revenues, or at least a predominant amount would be used for that purpose, leaving little, or none, for current gas purchase costs under existing contracts above spot market prices (i.e., WACOG). In fact, the Commission's Proposed Policy Statement on the Interim GIC's makes that exact point in the discussion of the spot market interim GIC and the example in the Appendix. By dramatic comparison, the Commission staff analysis assumes that every penny of the additional revenues generated by the GIC adder would go to such current gas purchase costs to supplement the spot market prices, as if it were a PGA passthrough, and not one cent from those revenues would ever be used to fund take or pay-related costs. Once having substituted that "shell-game" type of "now you see it -- now you don't" revenue assumption, the Commission staff analysis blithely concludes that "all is well" because such wholly fictitious use of every available penny for current wellhead purchases under existing contracts would happily only reduce natural gas producer revenue by 8.1% on a conservative basis or 5% on a less-conservative basis. That analytical effort, and the GIC policy it attempts to support, is hardly a mere arithmetic exercise. For all practical purposes, this after-the-fact Commission staff "analysis" is little more than a political palliative to attempt to explain away the clearly intended and virtually inevitable result of the original spot market GIC, as I testified at the hearing, i.e. immediate rampdown of the current WACOG under existing contracts to the spot market price.

III. Questions from Senator Ford

Senator Ford comments that the Commission must complete efforts to provide for a pipeline sales function to operate in the "open access" competitive transportation environment. I agree with that position.

Question 1. Senator Ford asks if there are legal or policy impediments to prompt action on pipeline settlements supported by the pipeline customers. I generally agree with the Commission staff answer. I strongly support the notion that such settlements should not be allowed to frustrate the Commission's concerted efforts to implement the Rate Design Policy Statement on all interstate pipelines as soon as possible. To date, I have supported Commission decisions which strike a balance between 1) approving settlements on an expeditious basis and 2) implementing the Rate Design Policy Statement.

Question 2. Senator Ford asks if the Commission has adopted an internal policy that would preclude interstate pipelines from being able to compete with others in the sales function on a comparable basis. I generally agree with the Commission staff answer. I would note that until recently in the transition since 1985, it has been quite obvious that non-pipeline merchants have been at a competitive disadvantage by comparison to the pipeline merchants. Various actions by the Commission, such as various features of GIC requirements, Order No. 436 requirements, the Rate Design Policy Statement, Order No. 497, and conditions on pipeline-customer settlements were intended to mitigate such clear competitive advantages. In all respects, the Commission was not tilting against the pipeline merchant, but rather seeking to create a fair and "level" competitive playing field for all merchants, including both pipeline and non-pipeline merchants. At the same time, however, I am not aware of any "internal policy" to disadvantage competitively the pipeline merchants.

Question 3. Senator Ford asks about the potential take or pay exposure that may accrue from March 31, 1989, the deadline for Order No. 500 direct billing filings other than contracts in litigation or arbitration, and the time a pipeline's GIC certificate becomes effective. I agree generally with the Commission staff response. I would add two additional points. First, the interim GIC concept in some form may serve as a bridging mechanism to cover take or pay-related costs until a permanent GIC is approved. Several pipelines already are pursuing that approach for the intervening time frame. Second, the Commission must redouble its efforts to expedite the processing of permanent GIC proposals by pipelines. To that end, I have proposed that the Final Order No. 500 rule incorporate some form of procedural or substantive provision that would provide for expedited treatment. I am persuaded that pipelines and other segments of the industry will be best served by the certainty, predictability and stability that should occur upon approval of a permanent GIC for a given pipeline.

Question 4. Senator Ford asks about the relationship between the service obligation, the GIC and the expiration of the contract under a GIC. I agree generally with the Commission staff response. In particular, the implementation of a GIC should not become a prescription for the automatic abandonment of the pipeline's service obligation upon expiration of the original contract. Any decision on the abandonment of the sales service obligation should be based on a case-by-case review of the facts.

Question 5. Senator Ford asks if a spot market GIC would retard exploration and development through a backdoor reimposition of price controls. I disagree with the Commission staff response which answers in the negative for the reasons set forth in my testimony, as well as the analysis presented by Senator Dominici and Senator Nickles in their questions at the hearing. It is inconceivable that the dramatic loss of revenue to producers documented in the E.I.A. report for Senator Domenici could do anything but retard exploration and development. The Commission staff response argues that market conditions (i.e. supply and demand) will set prices that will determine the amount of exploration and development, if pipeline sales are set at the spot market price. That is the same rationale used to justify driving current prices under existing contracts from the WACOG to recent spot market prices, with a resulting 25% loss of revenues as estimated by EIA. The mechanism and the inevitable result are tantamount to the reimposition of wellhead controls.

Questions 6, 7, and 8. Senator Ford asks about exemptions of small general service customers under proposed GICs. The Commission staff responses to these questions provide a summary of current proposals and their respective treatment of small general service customers. I should note that the proposals approved thus far incorporated such an exemption. Also, as a matter of policy, I believe generally that there should be a presumption that small general service customers should be exempted, unless the pipeline demonstrates that there is an overriding, competing consideration in a particular case.

IV. Questions from Senator Nickles

Question 1. Senator Nickles requests a copy of the draft order dealing with the Transco interim GIC from the February 15, 1989 meeting and a copy is provided. I would note that this order includes the spot market interim GIC which spawned today's debate about spot market pricing. It forms the basis for the so-called competitive GIC in the Commission's Proposed Policy Statement on Interim GIC's, about which I wrote at length in my concurring opinion to that Proposed Policy Statement. It was this February 15, 1989, proposal which was clearly and expressly intended, upon generic implementation across the industry, to rampdown WACOG prices under existing wellhead contracts to the prevailing spot market price, as discussed in my prepared testimony and the aforementioned concurring statement. I would note in passing that the discussion of the Reconciliation Mechanism, beginning on page 9 of the draft order, makes clear that revenues would be the sum of 1) charges of gas actually sold with spot prices as a maximum and 2) a gas inventory charge set at 11.54 percent of the spot price index. These total revenues would have to cover Transco's actual payments for 1) gas purchased and resold as a merchant and 2) carrying charges on gas options payments, take or pay buyout/buydown settlement payments and contract reformation costs. Consequently, under the February 15 proposal, as well as the later competitive price proposal in the Proposed Policy Statement on Interim GICs, it is difficult to comprehend how such revenues could be expected to support longer term contracts and the current WACOG, as argued by the Commission staff in response to Senator Bingaman's questions about the EIA study.

Question 2. Senator Nickles asks about the impact of spot market pricing of GIC's on producers, because of the pressure that would be exerted on pipelines to reduce prices paid to producers under existing contracts or abrogate them altogether. I disagree with the Commission staff response for the reasons set forth in my testimony and earlier answers. In particular, I think that there is a crucial difference between the operation of the natural gas markets and the economic relationship between spot prices and WACOG-level prices, on the one hand, and governmental action through the spot market GIC to impose as a practical matter spot prices at the wellhead for all contracts, on the other hand. To the extent that market conditions exert downward pressure on prices significantly above spot market, as has occurred without doubt, and the parties to the contract voluntarily renegotiate to so-called market responsive pricing, or continue longer term contracts with pricing indexed to spot prices or even terminate the existing contracts under applicable regulations, that is a legitimate exercise of the parties' business judgment. It is quite another, and unacceptable, matter in my judgment for the Commission by regulatory action to impose the rampdown of current prices under the spot market GIC, thus exercising a governmental judgment that all natural gas wellhead pricing should be based on and reflect spot market pricing. Therein lies the policy disagreement for me with the spot market GIC as proposed. The Commission staff response makes clear that producer wellhead prices that are too far out of line with the spot market prices are simply not acceptable. As I stated in my testimony, the purpose of the spot market GIC was twofold: First, to make pipeline sales directly competitive with spot market sales and second, to prevent any future buildup of take or pay by forcing prices down to spot market levels.

Question 3. Senator Nickles asks about the Commission authority to deny passthrough of amounts actually paid to producers under Sec. 601 of the NGPA. I agree with the Commission staff response that absent fraud, abuse or similar grounds, FERC cannot deny the passthrough of such amounts.

Question 4. Senator Nickles asks about the use of revenues from the GIC adder to maintain gas supply. For the reasons set forth in my answers to Senator Bingaman's Questions 1(a) and 1(b), I disagree with the Commission staff response.

Senator Nickles also asks about the use of the GIC revenues and whether there is any requirement in the Proposed Policy Statement that they be used to maintain an inventory of gas, with an appropriate share for smaller producers. As discussed above, the revenues under the spot market GIC proposal would be used for current gas costs and all take or pay related costs, possibly including gas futures as in the February 15 draft order, at the sole discretion of the pipeline.

Question 5. Senator Nickles asks several questions about the operation of the spot market GIC by comparison to the WACOG in various situations. I disagree with the Commission staff responses for the reasons set forth in earlier answers. The bottomline is that in today's market a generally applicable spot market GIC would not generate sufficient revenues to support the WACOG under existing contracts, because it simply is not designed, nor intended, to do so.

Question 6(a). Senator Nickles asks about other formulations of the GIC proposed by commentors on the Proposed Policy Statement. I agree generally with the Commission staff response. I would add that the more detailed comment summary provides a complete survey of option, based on which I developed my prepared testimony about the consensus for flexibility and opposition to spot market GICs as proposed.

Question 6(b). Senator Nickles asks if it is necessary to tie the GIC to a spot market index. For the previously stated reason, I oppose such a direct tie to spot market prices. The Commission staff suggestion of using a published index for long-term contracts, if one existed, is completely new and novel. It is not clear at first blush how the use of such a theoretical long term index would differ materially from the WACOG over time, by comparison to the quite different, volatile and seasonal spot price index. Perhaps, the Commission staff response of a long term contract price index suggests a far more prudent, rational and responsible alternative for resolution of the spot market GIC worthy if further exploration (whether the suggestion was intentional or inadvertent).

Question 7. Senator Nickles asks about the proposed reconciliation mechanism and the possibility of challenges to the uses of the revenues. The Commission staff response generally is an accurate representation of the proposal. Clearly, the Commission envisioned that there would be the opportunity for challenges on grounds such as fraud, abuse, and prudence.

Question 8. Senator Nickles asks about the requirement in the Proposed Policy Statement that a pipeline must offer firm transportation service to customers under certain circumstances. I agree generally with the Commission staff response.

Question 9. Senator Nickles asks about the problem of automatic pregranted abandonment of firm transportation service selected by customers converting from CD sales service. I testified in support of an amendment to the regulations under Order No. 436/500 to repeal the pregranted abandonment of FT service after the first contract expires, and have pursued that objective in the Commission's subsequent discussion of Order No. 500 at the October 5, 1989, public meeting. While the case by case negotiated approach described in the Commission staff response may yield the same result in many cases, the fact remains that the current regulations provide a legal right to pipelines for such pre-granted abandonment. Thus, repeal of that provision by amendment of the regulations in the Final Order No. 500 would remove the cloud of uncertainty noted in Senator Nickle's question.

IV. Questions from Senator Domenici

Question 1. Senator Domenici asks about the impact of the spot market GIC in terms of wellhead prices and consumer interests. I disagree with the Commission staff responses for the reasons stated earlier.

Question 2. Senator Domenici asks about the likely impact of the Commission interfering in the wellhead pricing of gas, given the past history of Commission regulatory initiatives in that area prior to enactment of the NGPA. I disagree with the Commission staff response for the reasons stated earlier. I would only note once again that the staff response is tantamount to the explanation of why it was intended that current prices under existing contracts be ramped down to spot market prices.

Question 3. Senator Domenici asks whether an amount other than the actual amount paid by a pipeline for gas can be deemed just and reasonable without violating the spirit and letter of Section 601 of the NGPA. I do not support the answer ("yes") or the legal analysis of the Commission staff with unqualified support for that answer. I believe that legal analysis would turn the plain meaning of Sec. 601 on its head and provide the Commission with virtually unlimited authority to approve market pricing of purchased gas, in lieu of actual costs incurred. I also do not believe that the cited case (Transcontinental) can be read as standing for that proposition.

Question 4. Senator Domenici asks whether the denial of passthrough of gas costs above spot market prices as not being just and reasonable by the Commission under some claim of authority would mean that the Commission could reimpose wellhead price controls, despite the Natural Gas Wellhead Decontrol Act of 1989. The Commission staff response agrees with that conclusion, absent a finding of fraud, abuse, or similar grounds, but disclaims any intent to reimpose indirectly wellhead price controls. Irrespective of stated intentions one way or the other, I believe that the practical result of the proposed spot market GIC is the same, i.e. imposition of a Commission mandated price cap tied to spot market prices (and unrelated to current gas costs). Consequently, I also believe that the practical result of the proposed spot market GIC would be to establish regulatory conditions supporting pipeline claims of force majeure or exercise of contractual FERC-out provisions. As I testified, that clearly was the original intent of the February 15 draft order to thereby rampdown the WACOG to spot price levels.

Question 5. Senator Domenici asks for the Commission's analysis of the impact of the two primary alternatives included in the Proposed Policy Statement on Interim GIC. As discussed in response to Senator Bingaman's question, there had been no quantitative or qualitative analysis of either alternative to my knowledge, until the recalculation of the EIA data summarized in the Commission staff response to Senator Bingaman. As discussed there, I believe that recalculation of the EIA data is fatally flawed, because of the fundamental assumption that all revenues would be used solely for direct gas acquisition costs.

Question 6. Senator Domenici asks about the accuracy of the Proposed Policy Statement insofar as the "true" market price using spot market prices, whether spot market indexes are weighted by volume and if there will be any verifications or audits of the indexes. I disagree strongly with the statements in the Commission staff response about "true" market price and what was intended by the proposed spot market GIC for reasons stated above. I also would note that the fact that the spot market indexes are not weighted by volume and are largely anecdotal (rather than systematic) adds to concerns about validity and volatility, particularly in a relatively "thin" market (which also introduces concerns about geographic and pipeline specific forms of price index manipulation). The Commission staff proposal to use spot market indexes meeting other conditions does not obviate those very valid concerns, in my judgment. The dismissal out of hand of verifications and auditing by the Commission staff may ignore a serious practical problem, if spot market GIC pricing is ever implemented on a generic or broad-based basis.

Question 7. Senator Domenici asks about the necessity for comparability in firm transportation services as compared to firm sales, as a condition precedent to approving a GIC for a particular pipeline. I agree with the Commission staff response that there should be such comparability. I also would note that the Rate Design Policy Statement now seeks consideration of the same result.

Question 8. Senator Domenici asks about whether the interim GIC would be de facto permanent, just as the interim Order No. 500 has become a de facto Final Rule. As discussed earlier, the interim GIC for some pipelines may be able to serve as a useful bridge this winter, until the permanent GICs are in place sometime next year. While an interim GIC may eventually be converted into a similar permanent GIC under appropriate procedures, the general intention would be to have them as distinct options.

Question 9. Senator Domenici asks for Commission comment in response to the filing by the Illinois Commerce Commission criticizing the operation of the spot market GIC as subverting the actual spot market by reestablishing a pipeline monopoly presence. He also asks whether the proposed reconciliation mechanism would provide pipelines with interest free loans. The Commission staff responses acknowledge that there is the possibility of the problems identified by the Illinois Commerce

Commission, but suggests that the problems would not be significant. I believe that the Illinois Commerce Commission has identified problems that require further study and careful consideration in any final policy statement, particularly with regard to any substantial over-recoveries or interest free benefit. I also would reiterate that the spot market GIC had as an overall objective making pipelines directly competitive with non-pipeline, spot market merchants, in order that the pipelines would be far more competitive and would thereby recapture lost sales markets. Such a result clearly would increase materially pipeline market power, if not the earlier sales monopoly.

Question 10. Senator Domenici asks whether the Commission's recent decision in the Panhandle case (Docket No. RP89-185-000) approving a form of spot market interim GIC called a Seasonal Sales Program (SSP) was anticompetitive, inconsistent with the Proposed Policy Statement, inconsistent with policy embodied in Order No. 380, and potentially harmful to producers and competition generally. I disagree with the Commission staff responses. I dissented in this case precisely because the Panhandle SSP proposal was anticompetitive on its face and totally inconsistent with the Proposed Policy Statement, as well as potentially very harmful to Panhandle's captive producer suppliers. In retrospect, the SSP proposal also is inconsistent with the policy embodied in Order No. 380. I look forward to rehearing of that decision.

V. Questions from Senator Wallop

Questions 1 through 6. Senator Wallop asks a series of questions about the status of the Kern River certificate filing for a new interstate pipeline to serve California. I agree generally with the Commission staff responses. I would only add that a majority of the Commission had spoken over time about the need for an Initial Decision in the Kern River section 7 proceeding. In retrospect, the entire proceedings on new pipeline capacity for California would have been served better if we had adopted a deadline last year of July 1, 1989 for issuing that Initial Decision, when we acted on the Wyoming-California OEC proposal and subsequently on the Mojave OEC proposal. Nevertheless, at this advanced stage of the proceedings, I believe that principles of fundamental fairness demand that we act as expeditiously as possible on the new Kern River OEC filing and the associated amendment to the Mojave certificate already issued. If the California marketplace ultimately is to make the decision as to which proposals or group of proposals ultimately will proceed to construction, the Commission is obligated to complete promptly the necessary Federal regulatory reviews to support that approach. To fail to act now at this critical stage of the competitive process would, for all practical purposes, be tilting toward competing projects. Such a result would be contrary to the Commission's long held and oft expressed view that the market would decide the competition, rather than Federal regulators by action or inaction.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

October 27, 1989

OFFICE OF THE COMMISSIONER

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
Development and Production
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of October 2, 1989, forwarding questions from Senator Metzenbaum with regard to the Subcommittee's September 14, 1989, oversight hearings on Gas Inventory Charges (GICs).

I have reviewed the responses prepared by the Commission staff and transmitted to you by Chairman Hesse by letter of October 25, 1989. I am in general accord with the policy thrust of those responses. I also have reviewed Commissioner Stalon's separate responses and, apart from our continued disagreement about spot market GICs, believe he has added useful observations about the Commission staff responses.

Thank you again for the opportunity to participate in the Subcommittee's oversight review of this important issue.

Sincerely,

Charles A. Trabandt

Charles A. Trabandt
Commissioner

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

OFFICE OF THE COMMISSIONER

October 10, 1989

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral
  Resources Development and Production
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

My responses to the written questions asked for the Subcommittee's hearing record on Gas Inventory Charges are enclosed. I agree with the Commission staff's responses to the Subcommittee's questions that are being forwarded by Chairman Hesse, except as noted in the enclosed.

If I can be of further assistance please let me know.

Sincerely,

Betsy

Elizabeth A. Moler
Commissioner

Enclosure

QUESTIONS FOR THE RECORD FROM SENATOR FORD
ANSWERS FROM COMMISSIONER MOLER

Question #3:

What are you going to do about the take-or-pay that accrues between March 31, 1989, the cutoff date for take-or-pay settlement recovery, and the time a company has its GIC approved by the Commission?

Answer:

I do not believe that the Commission has taken sufficient steps to deal with the potential problem of take-or-pay (TOP) costs accrued after March 31, 1989, and before implementation of a GIC. A GIC would enable a pipeline to include TOP costs in its demand charge. Absent a GIC, such costs must be recovered in the pipeline's commodity costs for gas. Pipelines compete against other non-regulated merchants who do not have to reflect TOP costs in their commodity cost. Those merchants can undercut pipeline commodity prices but the pipeline still has an independent certificate obligation to serve its customers and thus must insure that long-term supplies are available. Approval of a GIC accomplishes two things -- it enables the pipeline to charge its customers its actual costs of securing long-term supplies. The Commission also adjusts the pipeline's service obligation upon implementation of the GIC to reflect its customers' current needs. Fundamentally the potential for a problem is there.

Question #4:

The Commission presumably intends that the GIC become incorporated into the pipeline's service obligation. But because the pipeline's obligation to serve continues beyond the life of the contract, doesn't that continued obligation conflict with the concept of a GIC as presented in Order No. 500?

Would the Commission grant abandonment of a GIC to a pipeline that cannot negotiate a new contract with a customer?

Would it grant the abandonment if the customer opposed it?

Answer:

I concur with the staff response, but believe another point needs to be made.

A prerequisite to implementation of a GIC is the ability for a pipeline's customers to reflect their current gas supply plans by nominating new levels for firm sales (D-1 and D-2 charges).

The Commission also allows the pipeline to adjust its certificate service obligation accordingly when a GIC is approved. In addition, to the extent that sales customers convert to transportation, the Commission has provided an opportunity, pursuant to §284.10 of our regulations, for the pipeline to seek pre-granted abandonment of its old service obligation levels.

Question #5:

Would basing a GIC on the natural gas spot market retard exploration and development through a back door reimposition of wellhead controls?

Answer:

I do not believe that a GIC based on spot prices legitimately translates to "back door reimposition of wellhead (price) controls."

QUESTIONS FOR THE RECORD FROM SENATOR DOMENICI
ANSWERS FROM COMMISSIONER MOLER

Question #1(a):

It appears that the proposed spot market gas inventory charge (GIC) adversely affects both producers and consumers.

(a) Would you agree that the spot market GIC ("competitive price concept") -- even if the Commission does not deems it to be just and reasonable -- would put a great deal of pressure on pipelines to push wellhead prices down towards the spot price?

Answer:

I believe there is already a great deal of pressure on pipelines to push wellhead prices down towards the spot price. Fundamentally pipelines are competing against other non-regulated merchants, who do not have a service obligation, who are able to sell at spot prices. The idea behind a GIC, whether it is based upon a percentage of a pipeline's weighted average cost of gas (WACOG) or a spot market price, is to enable the pipeline to pay its suppliers more than spot prices if necessary to secure long-term contracts and to cover any take-or-pay (TOP) charges that may be accrued.

Question #1(b):

If the spot market GIC is deemed to be just and reasonable, would you agree that that would virtually guarantee that wellhead prices would fall to the spot price?

Answer:

New natural gas purchase contracts already reflect wellhead prices that are largely based upon spot prices. Typically short-term contracts are simply spot price transactions. If a producer is willing to enter into a longer term contract -- and these days six months is long term -- the price is typically "spot plus", i.e., a spot plus a percentage. This is true in the absence of a GIC, with any type of a GIC, and in unregulated transactions as well.

Question #1(c):

If the spot market GIC results in reduced exploration, would you agree that consumers would be adversely affected over the long run by reduced supply and increased prices, even though they may benefit somewhat from lower prices in the short run?

Answer:

Yes, if the stated assumption is correct.

Question #1(d):

Would you agree that it would be possible to design a GIC which instead simultaneously benefits consumers and all segments of the natural gas industry?

Answer:

Yes.

Question #2:

During the 1960s and 1970s the Commission kept the wellhead price of natural gas artificially low, and that led to shortages in the interstate marketplace. Those growing gas shortages -- culminating with the severe shortage during the winter of 1976-77 which closed schools and businesses in the Midwest -- led to the enactment of the Natural Gas Policy Act of 1978.

The NGPA recognized and did away with the problems of having a dual market and interfering with wellhead prices, although for political reasons not all natural gas was to be deregulated pursuant to it. Congress only recently finished the job begun by the NGPA, and has now set a timetable for total wellhead decontrol.

It would appear, however that the Commission is proposing to turn back the clock by artificially suppressing the wellhead price of natural gas in interstate commerce, albeit through a new regulatory mechanism -- the spot market GIC.

Do you think that the consequences of artificially interfering in wellhead pricing -- assuming that such action is lawful -- would result in any better outcome now than it did in the 1960s and 1970s?

Answer:

I concur with the staff response, but believe another point needs to be made. I do not believe that either type of GIC, whether it is based upon spot prices or whether it is based upon a percentage of a pipeline's WACOG, is intended to or will have the effect that wellhead price control had.

Question #3(a):

Section 601 of the NGPA provides for the automatic passthrough by pipelines of amounts paid for the purchase of natural gas.

(a) As a matter of law, do you believe that the spot market GIC, or any amount which is other than that which a pipeline actually pays for gas (be it higher or lower), can be deemed to be just and reasonable without violating the spirit and letter of section 601?

Answer:

Deeming a GIC "just and reasonable" under the Natural Gas Act means that it can legally be charged by a pipeline selling natural gas to its customers. It does not affect the pipelines' legal right to pass through its costs under Sec. 601 of the NGPA.

Question #4:

Assume for the purpose of analysis that notwithstanding the clear meaning of section 601 of the NGPA, the Commission somehow found the authority to deny the passthrough of gas purchase amounts above some Commission-established level -- say spot market prices -- as not being just and reasonable.

a. As a practical matter wouldn't that mean that notwithstanding the recent Congressional elimination of wellhead price controls, the Commission could reimpose wellhead price controls, albeit indirectly?

Answer:

I concur with the staff response, but believe another point needs to be made. The question recognizes its own contradiction. It is not reasonable to "assume for the purpose of analysis" that section 601 of the NGPA would not apply.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

OFFICE OF THE COMMISSIONER

October 25, 1989

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
Development and Production
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I agree with the Commission staff's replies to the additional questions for the hearing record submitted by Senator Metzenbaum.

With best wishes,

Sincerely,

Betsy

Elizabeth A. Moler
Commissioner

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

October 10, 1989

OFFICE OF THE COMMISSIONER

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
Development and Production
Committee on Energy and Natural
Resources
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of September 20, 1989, enclosing post-hearing questions pursuant to the September 14 oversight hearing on Gas Inventory Charges.

I am in substantial agreement with the Chairman's responses to your questions, however, where I have a slightly different opinion, I have answered those questions separately and have enclosed them herewith.

If you need additional information, please do not hesitate to contact me.

Sincerely,

Jerry J. Langdon
Commissioner

Enclosure

QUESTIONS FOR THE RECORD FROM SENATOR BINGAMAN

Question 1(b): Has the Commission performed any independent analysis of the likely producing sector impact of its pprposed GIC policy?

Answer: While I agree in general with the Chairman's answer, it is important to note that the conclusions drawn from the analysis of Tables 1Aa and 1Ab assume current market conditions, ie., approximate equilibrium of deliverable gas supply and demand for natural gas. If deliverable supply continues to shrink in relation to growing demand, these conclusions may become inaccurate or irrelevant.

QUESTIONS FOR THE RECORD FROM SENATOR FORD

Question 3: What are you going to do about the take-or-pay that accrues between March 31, 1989, the cutoff date for take-or-pay settlement recovery, and the time a company has its GIC approved by the Commission?

Answer: I agree with the Chairman's answer to this question. However, the answer may change depending on the content of final Order No. 500, which was discussed at the Commission meeting on October 5, 1989 and will be issued in the near future.

SENATOR NICKLES QUESTIONS

Question 2: Many producers are concerned that the Commission's proposed spot market GIC (the so-called "competitive price concept") will put a great deal of pressure on pipelines to reduce the amount they pay producers for natural gas, or even to abrogate wellhead purchase contract altogether -- particularly if the spot market GIC is deemed or held by the Commission to be the just and reasonable amount. Do you share any of these concerns? What would be the consequences to domestic production and producers, particularly independents, if that were to occur?

Answer: Although I agree with the Chairman's answer to the above question, I am concerned that the portion of the answer that states that the spot market based purchases of the interstate pipelines will likely affect wellhead purchases, "particularly if a producer's wellhead prices are out of line with the spot price" (emphasis added) may imply that contract abrogation by the pipeline of producer contracts may somehow be condoned by the Commission in the future. The Commission has taken the position that the unilateral abrogation and abandonment of producer contracts by a interstate pipeline company would require the Commission to utilize its authority under Section 5 of the Natural Gas Act. The Commission has also resisted the Section 5 remedy and has stressed to the parties the importance of reaching negotiated settlements of contract disputes.

Additionally, per the final statement in the Chairman's answer:

> "The demand for spot market supplies at the spot market price is one indication of short term gas demand at a particular price and under particular contract terms."

This statement implies that other types of indexes will/may develop to satisfy the inaccuracies of using short-term (30 days) pricing scenarios to index to long-term (1-10 year) pricing. To the contrary, adoption of the proposed spot-market concept for gas pricing will inhibit development of better indicators of long-term contracting trends within the industry in the future.

Question 5(a): One of the fundamental defects of the proposed spot-market GIC is that it ties the price of pipeline gas sales to an artificial index. That index now is below most pipelines' WACOG, because of the softness in the gas market.

(a) If the market tightens, wouldn't the Commission's spot market GIC then result in above-market and above WACOG prices set for the GIC? What would happen then? What are the implications to consumers?

Answer: Again, I find myself in substantial agreement with the answer supplied by the Chairman, except for the fact that I do not share her confidence that it is yet "a properly operating spot-market." To be sure, the market has made significant progress toward obtaining that status; however, it falls short in several notable categories. Please see my answer to Senator Domenici's Questions 6(b) and (c).

Question 5(b): If the GIC is below WACOG wouldn't pipelines get "stuck" with the difference between that which they paid for gas and that which they sold it for? What are the implications of that for pipelines and producers?

Answer: I would endorse the Chairman's answer to the foregoing question but for the fact that it relies on a false premise in my opinion. That is that all wellhead markets are competitive. In the instant example, one would assume that the producer might benefit from GIC payments if he had other pipeline purchase or transportation alternatives and if the pipeline needs the producer's gas supplies to meet demand. However, the producer who has no alternative purchaser or transporter will be facing, in all likelihood, a reduction in price to the spot level, less the pipeline transportation component of it sales rate.

The Chairman's answer properly excludes producer contracts the pricing of which fall within the mid-range of seasonal variations.

Question 6(b): With respect to the proposed "competitive price concept," is it necessary to tie the GIC to a spot market index?

Answer: I am concerned that the adoption of improperly operating spot-market indices for utilization in GIC's, Seasonal Sales Programs (SSP's) or other service restructuring proposals will significantly inhibit the development of more useful long-term pricing indexes. If the Transco mechanism for establishing GIC pricing is adopted on a generic basis, the long-term index alluded to in the Chairman's answer could be extrapolated by simply adding 11.25% to the spot index.

SENATOR DOMENICI QUESTIONS

Question 1(b): If the spot market GIC is deemed to be just and reasonable, would you agree that that would virtually guarantee that wellhead prices would fall to the spot price?

Answer: Please refer to my answer to Senator Nickles Question #2. I object to the answer submitted by the Chairman because I believe it is premised upon a false assumption that all wellhead markets are truly competitive. Moreover, I do not agree as a general principle that because long term prices have been greater than short term prices during this period of oversupply, this nexus will necessarily continue in a period when demand is greater than or substantially equal to supply.

Questions 6(b) and 6(c): Is it true that the prices used in the spot market GIC calculations are not weighted by volume? Would the use of unaudited and unverified data provided by pipelines to trade publication present any potential or incentives for abuse? Has the Commission itself verified that the prices reported to these trade publications are correct?

Answer: I have taken the liberty of combining the two questions above, as I believe they both relate to the question of a "properly functioning" spot market. As I have previously stated publicly and elsewhere herein, I am concerned that the Commission has been over-anxious to endorse spot price indices in the various case-by-case applications without regard to how properly the index is functioning. At a minimum, the Commission should adopt and consider the following factors before using any price generated from spot-sales:

1.) If the spot price category, (ie. southwest, mid-continent, northwest, southeast, etc.) as identified by the various trade publications, is so regional that the purchasing activities of a given pipeline could directly affect the resulting price, the Commission should consider establishing regions based upon historically competitive pipelines.

2.) The current trade publications may not be the only viable source of price information in the future. The Commission should audit the information on a regular basis to determine if the information is the best available. The Commission should at the outset make provisions for future consideration of other suitable public sources.

3.) All spot prices considered by the trade publications should be standardized to consider among other things, whether the spot-price as published is a function of volume, whether or not gas is wet or dry, and its pressure; whether the price is net of gathering and transportation; the length of the contract, firmness of the delivery obligation, etc.

4.) The Commission should instruct the trade publications to exclude contracts where there is a known lack of competition at the wellhead.

5.) The Commission should insist at a minimum that any spot-market pricing index used in the context of GIC's, SSP'S or service restructuring be for the contemporaneous month and/or sales period. Alternatively, the spot-prices used in the context of GIC's, SSP's or service restructuring should be adjustable in real terms to the contemporaneous period.

QUESTIONS FOR THE RECORD FROM SENATOR DOMENICI FOR COMMISSIONER LANGDON ONLY

Question 1: As your written testimony states, your dissent in the *Panhandle* case (Docket No. RP89-185-000) indicates you feel uncomfortable about using the spot market to establish gas inventory charges. Would you be as equally uncomfortable in using the spot market methodology to establish a generic GIC policy?

Answer: The use of the spot market was one of my concerns in *Panhandle*. Panhandle, unlike Transco (Docket No. CP88-391-000), proposed to use a spot market reference that was based on a regional average in a region where there arguably is limited pipeline competition in some areas and Panhandle's purchases will affect the level of the spot market price. Equally troubling was the timing for the use of the spot market reference. Basing Panhandle's commodity cost on the spot prices reported in a prior month can create a competitive advantage for Panhandle. Furthermore, I believed that the prospect of Panhandle direct billing customers for its unrecovered purchased gas costs would induce customers to purchase gas from Panhandle rather than another supplier, and makes the SSP function very much like a GIC. I was fundamentally disturbed that Panhandle's proposal (now pending on rehearing) was approved without any record to support the likely competitive consequences of the action taken, at both ends of the pipe.

By contrast, a record is being compiled in both the generic interim GIC proceeding and in individual proceedings which may support the spot market methodology. See answer to Question 2 below.

Question 2: You state on page 5 of your testimony that you question the use of the spot market index in the Panhandle case because there wasn't any record evidence to support its reliability as a pricing index. Is there any record evidence to support its use for interim GICs as proposed by the Commission's NOPPS?

Answer: The Commission and its Staff are in the process of reviewing the comments received in response to the NOPPS. That review, when completed, will determine the extent to which the record in the NOPPS proceeding supports the use of spot market prices as one of the components of an interim GIC.

In addition, the use of spot market prices is an issue that is being explored in individual GIC proceedings of Transcontinental Gas Pipe Line Corporation (Docket No. CP88-391-000), El Paso Natural Gas Company (Docket No. CP88-434-000, et al.) and Tennessee Gas Pipeline Company (Docket No. CP89-470-000, et al.). Hopefully, these proceedings will provide additional information about the behavior of the spot market and the ability of pipeline customers to obtain firm transportation fully comparable in quality to sales service.

COMMISSIONER LANGDON'S RESPONSE TO QUESTIONS FOR THE RECORD FROM SENATOR NICKLES

Question 4: The "inventory charge" element of both proposed GIC alternatives does not appear to bear any relationship to the cost of maintaining supply. Is there anything in the NOPPS which requires a pipeline to use the GIC supply security premium to maintain an inventory of gas? Is there anything in the NOPPS which requires a pipeline to ensure that an appropriate share of such amounts flow to smaller producers who have relatively less market power than major producers?

Answer: A major purpose of an interim GIC is to prevent buildup of further take-or-pay pending the adoption of a permanent GIC. Since the inventory charge concept described in Order No. 500 was related to long-term supply security, I have stated in the past that an "interim" GIC may be a contradiction in terms. To say this, however, is not to ignore the cost relationship between the level of the charge and what it is intended to do. An inventory charge based on a a deliverability factor percentage of a pipeline's pre-tax rate of return, for example (one of the alternatives upon which comments are requested in the NOPPS), would approximate the pipeline's current exposure to take-or-pay.

In response to the second part of the question, the NOPPS is not intended to affect the negotiation process between pipelines and producers and makes no distinctions on the basis of producer size. Therefore, the short answer is "no." However, the issues raised by your question could be discussed in response to specific questions included in the NOPPS, particularly Questions 5, 6 and 14.

COMMISSIONER LANGDON'S RESPONSE TO QUESTIONS FOR THE RECORD FROM SENATOR DOMENICI

Question 1(c): If the spot market GIC results in reduced exploration, would you agree that consumers would be adversely affected over the long run by reduced supply and increased prices, even though they may benefit somewhat from lower prices in the short run?

Answer: I agree with the answer supplied by the Chairman, provided that market signals are timely. However, past experience has shown that often they are not, and I am concerned that even relatively brief time lags may produce dislocations and shortages.

Question 10(a): In the recent Panhandle case (Docket No. RP89-185-000) the Commission approved a spot market GIC without any of the projections of the proposed spot market GIC: it allowed the customers of the pipeline to agree to buy a minimum quantity from the pipeline rather than from the pipeline's competitors, and did not require the pipeline to allow customers to nominate volumes freely. Is that anticompetitive or inconsistent with the Commission's open access transportation program?

Answer: As the Chairman's answer indicates, the majority in Panhandle distinguished Panhandle's program from a GIC. I dissented because I believe that the program raises some of the same concerns as a GIC and therefore should have been analyzed on the same basis. A copy of my dissent is attached.

Question 10(b): Is it inconsistent with the policy intent of the NOPPS?

Answer: As I stated in my dissent, Panhandle's SSP may behave much like a GIC. To the extent that the Commission's GIC policy includes an evaluation of supply alternatives, comparable service, and competitive consequences, I believe that not performing such an evaluation in the Panhandle case may have been inconsistent with Commission policy.

Municipal Defense Group
Natural Gas Pipeline Company of America
Northern Illinois Gas Company
Northern Indiana Fuel and Light Company, Inc.
Northern Indiana Public Service Company
Ohio Gas Company
Panhandle Customer Group
Panhandle Small General Service Municipal Group
Producer Associations **
Producer-Marketer Transportation Group *
Southeastern Michigan Gas Company
Tennessee Gas Pipeline Company **
Texaco Gas Marketing Inc.
Vesta Energy Company **

* Denotes persons filing protests.
** Denotes persons filing late interventions.

Jerry J. LANGDON, Commissioner, *dissenting:*

There are two reasons why I cannot support this order. The first is the decision to tie the determination of Panhandle's monthly commodity cost of purchased gas for a given month, to the prices paid in prior months. Since Panhandle will be posting its price for a particular month on the day before the beginning of the month in which the price will be in effect, the referenced average will be based on the spot market prices delivered into mid-continent pipelines in the prior month. For example, reported spot market prices in February will determine Panhandle's gas price in March, March spot prices will determine Panhandle's gas price in April, and so on throughout the year. In a gas market where variations of only a fraction of a cent in the price of natural gas can make the competitive difference between vendor selection, I am concerned that recent experience has shown that monthly price differentials can vary significantly. Accordingly, Panhandle would operate, by virtue of the advance posting requirement, at a great competitive advantage during periods when prices are trending upward. Moreover, I question whether Panhandle could meet prudence challenges during periods when prices are trending downward.

The general propriety of using "spot market" prices to establish a gas pricing formula has been identified as an issue requiring further evidentiary submissions in various gas inventory charge (GIC) proceedings.[1] I question whether the Commission has sufficient evidence here to conclude that Panhandle's proposed use of prior month's spot market prices, as modified by the advance posting requirement, meets the just and reasonable standard under the Natural Gas Act.[2] In particular, I am concerned that delays in reporting spot market prices will not provide a current, reliable reference and that Panhandle's sale will influence the spot market prices in the mid-continent area.

Second, I am not persuaded at this time that Panhandle's proposal will not give Panhandle another unfair competitive advantage over other sellers of gas. The order states that Panhandle's gas will be priced higher than the price customers would pay for spot market gas transported at interruptible rates. This comparison, however, ignores the likelihood of discounts (netted back to the wellhead) to compensate for the lower reliability of spot purchases. It also ignores the role of the Account No. 191 balance in influencing customers' purchasing decisions.

Although the program on its face does not require Panhandle's sales customers to nominate new levels of service or impose a penalty on their failure to take, in reality customers must choose between meeting 90 percent of their "best efforts" commitments or having Panhandle terminate the program before the end of the 21-month period in order to recover its $48.9 million Account No. 191 balance. In this sense, the prospect of being billed a portion of Panhandle's unrecovered purchased gas costs functions much like a GIC because it induces customers to purchase gas from Panhandle or pay an additional charge if they do not. Yet it lacks the safeguards of comparable access that would be required prior to implementation of a GIC, to ensure that purchasing decisions are based on meaningful service alternatives.

In short, I would reject Panhandle's proposal, without prejudice to Panhandle refiling a proposal to address future take-or-pay costs and/or other methods of dealing with accumulated Account No. 191 balances.

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[1] *See, e.g., Transcontinental Gas Pipe Line Corp.*, 46 FERC ¶ 61,364, at p. 62,137, *reh'g granted in part*, 47 FERC ¶ 61,244 (1989); *El Paso Natural Gas Co.*, 46 FERC ¶ 61,108, at pp. 61,306-308 (1989); *Tennessee Gas Pipeline Co.*, 47 FERC ¶ 61,245 (1989). *See also* Notice of Proposed Policy Statement on Interim Gas Inventory Charges, Docket No. PL89-1-000 [47 FERC ¶ 61,294].

[2] 15 U.S.C. § 717c(a).

Question 10(c): Is it inconsistent with the Commission's policy embodied in Order No. 380?

Answer: I assume that this question is directed toward whether Panhandle's program could be construed as requiring pipeline customers to pay variable costs that are not incurred. If so, the short answer is "no."

As the Chairman's answer indicates, there is no such requirement because customers theoretically remain free to purchase gas from suppliers other than Panhandle. If the customers do not meet 90 percent of their best efforts purchase commitment, and Panhandle decides to terminate the program early, the remaining costs in the deferred account that Panhandle will be entitled to recover represent unrecovered incurred costs of gas that has already been purchased. Panhandle's proposal to refund any overcollected balance at the end of the program means that Panhandle will not be able to use the seasonal delivery allowance component of its commodity rate under the SSP to recover unincurred gas costs.

Question 10(d): Did this decision help or hurt producers who sell to Panhandle, and competition generally?

Answer: The effects of the program on producers who sell to Panhandle, and on competition generally, are unclear at this point. I was concerned that the program was approved without a thorough prior evaluation of its likely effects, and that this approval may limit the Commission's options to correct adverse effects if they do occur.

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

October 25, 1989

OFFICE OF THE COMMISSIONER

Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral Resources
  Development and Production
Committee on Energy and Natural
  Resources
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your letter of October 2, 1989, enclosing post-hearing questions submitted by Senator Metzenbaum pursuant to the September 14 oversight hearing on Gas Inventory Charges.

I have reviewed the Chairman's response to Senator Metzenbaum's questions and agree with the answers she has submitted.

If you need additional information, please do not hesitate to contact me.

Sincerely,

Jerry J. Langdon
Commissioner

Appendix II

Additional Material Submitted for the Record

PENNZOIL EXPLORATION AND PRODUCTION COMPANY
PENNZOIL PLACE • P.O. BOX 2967 • HOUSTON, TEXAS 77252-2967 • (713) 546-4000

September 28, 1989

The Honorable Jeff Bingaman
Chairman
Subcommittee on Mineral
Resources Development and Production
Committee on Energy and
Natural Resources
United States Senate
Washington, D.C. 20510-3102

Re: Hearing on Oversight of Gas Inventory Charges

Dear Chairman Bingaman:

Pennzoil Exploration and Production Company ("Pennzoil") appreciates this opportunity to comment on the Subcommittee's September 14th Hearing on Oversight of Gas Inventory Charges (GICs).

Pennzoil is engaged in the exploration for, and the production and marketing of, natural gas; as a consequence, we were gratified to see the strong support by your Subcommittee for the interests and well being of those of us that explore for and produce natural gas. We are concerned, however, that the issues raised by the Subcommittee have not been fully addressed and, as a result, a great deal of confusion exists regarding competitive or demand-based GICs. Moreover, we believe that the confusion surrounding competitive or demand-based GICs has caused many people to lose sight of one of the most significant problems facing producers today, i.e. the fundamental imbalance between the obligations of buyers and sellers in the natural gas market.

The typical producer in today's market, especially the small producer that is unwilling or unable to engage in protracted litigation, is most likely faced with the following plight. The producer's contract will not be honored by the pipeline as long as it exceeds the spot market price, so the gas is temporarily released and sold by the producer in the spot market. The released gas will be transported by the pipeline and the producer will be forced to give Order No. 500 credit toward

SENATE COMMITTEE ON
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WASHINGTON, D.C. 20510

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any take-or-pay liability. The producer will be a low cost supplier in the marketplace until the spot price exceeds contract price, at which time the pipeline will exercise its recall rights to the producer's gas. The producer receives a false signal from the market that undervalues production which results in a decrease in the producer's exploration and production efforts.

Producers are victims of an imbalance that exists between the obligations of purchasers and sellers in the natural gas market. This imbalance was created by the Commission's issuance of Order No. 380 in 1984. Order No. 380 curtailed the use of minimum commodity bills which permitted pipelines to recover from their customers, a percentage of purchased gas costs incurred by the pipeline, whether or not the purchaser actually took the volume of gas that it paid for. After Order No. 380 producers continued to have a certificate obligation to supply pipelines and a contractual right to be paid by the pipeline; the pipeline continued to have a certificate right to receive gas from producers and a contractual obligation to take-or-pay for dedicated gas; and the pipeline continued to have a certificate obligation to supply gas on demand to its customers. The pipeline's customers, however, had no corresponding obligation to take gas or pay for the gas that the pipeline was required to stand ready to supply. The customer could "swing" between the pipeline and other suppliers with the knowledge that the pipeline was always obligated to supply on demand.

While Pennzoil is an ardent supporter of the free market place and the Commission's efforts to bring about a free market for natural gas; the fact remains that Order No. 380 did more than eliminate the purchaser's obligation to pay for gas not taken, it eliminated any obligation on the part of a purchaser to pay the costs associated with maintaining a future gas supply for that purchaser.

The lack of mutual obligation that exists between sellers and purchaser of natural gas, allows purchasers to make decisions regarding gas acquisition without assuming the full cost of those decisions. Purchasers may be willing to pay a premium for supply security in a competitive market, but they are not acting as they would in a truly competitive marketplace because they have a free "insurance policy" in the form of the pipeline's continuing supply obligation. Purchasers can buy gas on the spot market when those supplies are cheaper than the weighted average cost of gas (WACOG) for the pipeline's general system supply, and then call on the pipeline's supply obligations when spot market prices escalate. The producer has become a low cost supplier and the price signal sent from the market is that no value is placed on supply security.

The ability to "swing" with impunity has deleterious results for others in the market as well. The pipeline's supply obligation remains constant even though its purchasers' requirements fluctuate. The pipeline is then faced with the choice of continuing to contract with producers for gas that may not be taken and risk the recurrence of the take-or-pay problem, or reduce supplies under contract with the producer and risk supply shortages.

A review of reserves under contract to ten large interstate pipeline companies shows that on average these companies have reduced their contracted reserves by almost 50% from year-end 1985 to year-end 1988. Customers served by these pipelines are relying on the merchant function of these pipelines for "supply security" but it is doubtful that many pipelines still hold sufficient contracted reserves to perform the service. In the final analysis, the absence of a responsible purchasing chain has resulted in a false sense of supply security and producers' wellhead prices reflect the impact of this environment.

The imbalance in the obligations of buyers and sellers of natural gas is a fundamental problem that prevents accurate pricing signals from working their way down the supply chain to the wellhead - a problem that should be of concern to virtually all producers of natural gas. There may be several possible solutions to this problem, including GICs, and it may be that no one solution will work on all pipeline systems. It is essential, however, that producers focus on the real problem and work toward a solution that promotes a competitive marketplace and enhances the position of producers.

With respect to GICs, Pennzoil is on record as favoring demand-based GICs over deficiency-based GICs. Contrary to the inference from the EIA report submitted to Senator Domenici, properly designed demand-based GICs will not drive the wellhead price for gas down nor will they lead to contract abrogation.

The EIA report overlooks three important elements of a demand-based GIC: increased sales volume; supply aggregation; and GIC generated revenue.

The EIA analysis fails to recognize that pipelines will have revenue from GIC fees as well as the sales price for gas to acquire its gas supply. Moreover, the volume of gas currently sold under contract is a small percentage of total gas sold, and the bulk of this contract gas is high cost gas. As a consequence, the weighted average cost of gas (WACOG) currently sold under contract is high. With a demand-based GIC, the ability of purchasers to "swing" between pipeline sales and the spot market will be reduced, so that much of the gas currently sold on the spot market will be purchased by pipelines to meet their sales obligations. Pipelines will aggregate their larger volume of lower cost gas with existing contracts in a manner that allows current contracts to be honored while lowering the WACOG paid by purchasers.

Pennzoil is particularly concerned with the impact on producers of the currently discussed alternative to demand-based GICs - the deficiency-based GIC. Although Pennzoil believes that it is possible to design a deficiency-based GIC which would address the imbalance between sales and purchase obligations and promote competition in the marketplace, the deficiency-based GICs that have been proposed in various FERC proceedings serve only to perpetuate the monopoly position of certain pipelines over the firm service merchant function. In addition, the proposed deficiency-based GICs allow the purchasers to continue to distort the market by using producers as low cost "swing" suppliers for 40% of their gas purchases. With this design, 40% of producers' gas production will be sold in the spot market when spot prices are depressed and when spot prices recover to levels above the pipeline's contract price, producers will lose this market to the pipeline's monopolistic merchant service. Deficiency-based GICs tend to be proposed on pipeline systems that do not have conversions to firm transportation, which presents the producer with no true firm purchase competition to the pipeline's merchant service. We are concerned that opposition to demand-based GICs is being used by certain monopolistic pipelines and their supporters to advocate deficiency-based GICs that can be disastrous for producers in general and independent producers in particular.

The Honorable Jeff Bingaman
September 28, 1989
Page Five

We would again like to stress that the paramount problem faced by producers is the imbalance in buyer and purchaser obligations. While there may be differing views about the optimal solution to those problems, there should be no disagreement about the nature or significance of the problem to producers of natural gas. It is Pennzoil's hope that those of us that want to protect the interest of producers and promote a competitive market for natural gas, can work together to solve our common problem, rather than fight among ourselves while inadvertently providing support to those that would perpetuate the monopoly power of certain pipelines.

Very truly yours,

Jon Wilems

P. Jon Wilems by [illegible]
Vice President

NATURAL GAS SUPPLY ASSOCIATION

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GAS INVENTORY CHARGE (GIC)

QUESTIONS & ANSWERS

QUESTION: What is the purpose of a gas inventory charge (GIC)?

ANSWER: As currently envisioned by the Federal Energy Regulatory Commission (FERC), GICs are intended to compensate interstate pipelines for maintaining sufficient inventories of gas to supply sales customers on demand. The GIC also has the incidental effect of funding the resolution of the pipelines' "take-or-pay" liabilities which accrue as a consequence of customers not purchasing the amount of gas they contract for with interstate pipelines. This will be explained in more detail later.

After considerable discussion, the Commission now appears in agreement on the necessity and objective of these charges. The current debate has shifted to more technical issues concerning the way the charge is designed and implemented. On May 30, 1989, the FERC issued a Proposed Policy Statement regarding the establishment of an interim GIC and solicited comments from interested parties.

QUESTION: Why are GICs necessary?

ANSWER: Gas inventory charges are necessary because of the fundamental asymmetry in obligations between the pipelines and their sales customers. Interstate pipelines are obligated by contract, and reinforced by statutory obligations imposed by the Natural Gas Act (NGA), to provide reliable service to their firm sales customers, (i.e., to stand ready to provide gas upon demand within the sales customers' contract levels). In fact, under current regulations, this obligation runs beyond the term of those contracts unless the FERC grants an "abandonment" or termination of service. To satisfy this obligation, an interstate pipeline acquires a portfolio of gas, under long-term and short-term contracts with producers and other suppliers. The prices it pays producers for long-term gas may be above or below prices of short-term and/or spot gas supplies. The pipeline may also be obligated to pay the producer for some minimum volume of gas even if it doesn't take that gas.

Representing the Nation's Producers of Natural Gas

(This is called a "take-or-pay obligation.")

LDC's are currently under no obligation to buy or take the gas from the pipeline. For example, LDC's might decide not to purchase their contract gas supply from the pipeline (i.e., the pipeline's "system supply") when the price of natural gas on the spot market falls below the price at which the pipeline would sell the gas to the LDC's. Currently, LDC's do not even incur any supply charge if they do not take the gas for which they have contracted. While this may seem beneficial to the consumer, the pipeline is still faced with the costs of maintaining the total supply, because the customer may at any time demand its full contract quantity from the pipeline. Without a GIC or similar mechanism the pipeline is unable to recoup the costs it has prudently incurred in acquiring adequate supplies to meet those continuing requirements.

QUESTION: Why don't LDCs have a concurrent obligation to purchase gas from a pipeline?

ANSWER: In 1984, the Federal Energy Regulatory Commission (FERC) issued Order No. 380. That order changed the traditional supply arrangements between pipelines and their sales customers. Prior to the issuance of Order No. 380 pipelines were allowed to charge their sales customers for a minimum volume of gas whether or not it was purchased. These charges are better known as "minimum bills." The customer thus had a financial incentive (although no obligation) to purchase its contracted supply from the pipeline.

Order No. 380, however, required pipelines to stop billing for costs of gas not actually purchased. The elimination of these costs resulted in a decline of the pipelines' sales volumes since, as noted above, many LDCs purchased gas on the spot market when the price of gas fell below the pipelines' system supply. Thus, as a consequence of Order No. 380, sales customers were no longer motivated to purchase their full gas sales requirements from an interstate pipeline since they incurred no minimum bill charge. This resulted in a decline of pipeline sales and a simultaneous increase in the pipelines' take-or-pay liabilities with producers. Pipelines had to maintain the total supply coverage even if their customers were not buying it.

The FERC's rationale for issuing Order No. 380 was that minimum bills had an anti-competitive effect since they restrained sales customers from purchasing lower cost sources of supply. This was an admirable goal. Now that customers may choose among alternative supplies, however, it is recognized that, if the pipeline is chosen as a supplier or used as a back-up supplier, that pipeline needs to be fairly compensated for holding a supply inventory of gas to satisfy their firm sales requirements.

QUESTION: Given an interstate pipeline's obligation to serve, how does that relate to the GICs?

ANSWER: GICs are an attempt to compensate a pipeline for its obligation to provide a sales service by imposing appropriate costs on LDC's while preserving for each freedom of choice in selecting long and short-term supply sources.

QUESTION: The FERC is currently considering two types of GIC mechanisms. One is referred to as a deficiency-based GIC and another is referred to as a demand-based GIC. What is a demand-based GIC?

ANSWER: Demand-based charges assess a fee for each unit of gas the customer contracts for. The total amount of gas contracted for is called the "contract demand" -- it is the maximum amount of gas the customer "demands" that the pipeline "reserve" for that customer's account, whether the customer buys the gas or not. These charges are therefore thought as "reservation fees," and they are paid even if the customer does not take the gas. Under FERC's demand-based proposal, the GIC, or reservation fee, would be based on the pipeline's rate of return, and would equal about 22 cents based on a spot price of $2.00.

Additionally, the customer pays the pipeline a charge for each unit of gas actually taken. This is called the "commodity charge." Under FERC's demand-based proposal, the commodity charge would be a spot price, determined by referencing published prices for spot gas in the pipeline's supply area.

Once the customer has reserved a volume of gas by paying the demand charge for it, the pipeline cannot contract to sell that gas to anyone else. The pipeline can sell the gas elsewhere only in a last-minute "spot"-type of sale if the customer does not actually take the gas. The theory behind demand charges is that the pipeline could have earned more per unit of gas in a long-term sale if it has known the customer would not take the gas. But it did not know, and it was obligated to not market the gas elsewhere until the last minute in case the customer decided to take it. At the last minute, the price it gets for the short-term sale would (at least in today's market) be lower than the long-term potential price.

Critics of this approach contend that demand-based GICs are market-driven mechanisms which are difficult to define in a regulatory context. The advantage to this proposal, contended by some, is that the customer picks the level of commitment and pays for the reservation up front, leaving it free to buy short-term supplies from someone else if the commodity charge is lower.

QUESTION: What is a deficiency-based GIC?

ANSWER: Under deficiency-based proposals, customers also specify the annual maximum amount of gas they will buy ("contract demand"), but also specify the minimum they believe they will take ("threshold level"). A charge is assessed against any shortfall below the minimum. The theory is that if the customers buy below their minimums, they pipeline will be forced to buy below its minimum take levels from producers, and it will incur some sort of take-or-pay charge. The deficiency charge should cover the pipeline's take-or-pay costs.

Under FERC's deficiency-based proposal, the commodity charge (or charge per unit of gas actually taken) would be the weighted average cost to the pipeline of all the gas it purchases. Thus the pricing of gas by a pipeline would be the same under the deficiency method as it has been historically. Under this proposal, the deficiency charge would equal about 46 cents, based on a theoretical pipeline WACOG of $2.30.

QUESTION: Has the FERC given any thought to how GICs should be calculated?

ANSWER: Yes. There are two distinct views of the way to calculate these charges. One camp asserts that charges should be cost-based. Cost-based GICs examine the pipeline's costs related to maintaining gas supply contracts (e.g., contract reformation costs, future take-or-pay settlement payments, or premiums paid to producers for long-term supply commitments). In application, the GIC and its associated commodity rate would be designed to fund all prudently incurred gas supply costs at any level of customer demand. While this approach is in accord with the general proposition of utility regulation, in practice this will require the pipelines to estimate with some predictability these cost/volume relationships.

The other camp asserts GICs are intended to address pipeline operations in a competitive world, and the charges should, therefore, be market-based and largely derive from individual negotiations between the parties. Specifically, market-based GICs depend on competition to set and discipline the level of the charges. In practice, regulation rarely defines the market without altering that market. Much of the market-based discussion has thus been difficult because of the apparent need to apply regulatory tests. Market-based rates can be used when there is workable competition, i.e., when there is a competitive market. To date, the Commission has approved one market-based charge, and that was a unique situation when a pipeline had only one major sales customer and the customer had many supply alternatives. The Commission's proposal for an interim market-based GIC defines the inventory charge as a premium over a composite of spot prices.

QUESTION: Is it possible that a customer may be overcharged by paying for GICs?

ANSWER: That possibility exists for a cost-based charge. However, the FERC in its Proposed Policy Statement regarding GICs suggested the possible use of a "Reconciliation Mechanism" which is designed to return over-collections to the customers. The drawback of such a proposal is that the customers would not know the true cost of their purchasing decisions. Nor would such a proposal make the pipeline pay for the cost of those decisions on a current basis. Moreover, in cases where the reconciliation method only requires the pipeline to rebate if there are excess monies in the pool, competing merchants would have to substantially underbid the pipelines. NGSA contends that in a truly competitive market there would be no need for a reconciliation method. Competitive forces would ensure that a GIC would be set at a level that served its stated purpose, namely, providing a pool of money to provide for long-term availability of gas. However, because current markets are not truly competitive, some reconciliation method may be appropriate in cost-based GIC methodologies. Such reconciliations should be two-way.

QUESTION: Does NGSA support a particular type of GIC?

ANSWER: No. The mechanics of a particular GIC are far less important than the Commission's continuing efforts to resolve these charges with the broader policy objective of maximizing competition in the production, transmission and sale of natural gas. The heart of the Commission's natural gas policy is the development of competitive markets, and the interim GIC proposal is but one measure which can play a part in achieving that goal. In evaluating GICs, one must remain constantly sensitive to whether these charges, either singly or in concert with other measures, act to foster competition.

Both the demand-based and the deficiency-based models carry the potential to encourage the competitive ideal. Depending on market strategy, take-or-pay settlements, existing contracts and other circumstances, individual companies may prefer one type of GIC over another. Those differences aside, either method can be acceptable as long as it is coupled with an emphasis on promoting competition.

QUESTION: If NGSA does not advocate a particular GIC, does it support the Commission's general efforts to establish a GIC?

ANSWER: NGSA applauds the Commission's efforts to establish markets in which all merchants have a comparable opportunity to compete. In some markets there has already been significant progress toward this competitive ideal. Increasingly, customers have access to suppliers other than pipelines. Producers, too, increasingly have access to customers other than the pipeline merchant. The continued existence and development of these alternatives form the cornerstone of competition and the Commission's natural gas policy as a whole.

QUESTION: Aside from GICs, are there other obstacles that prevent the competition in many natural gas markets?

ANSWER: In many markets competition is impeded by an array of barriers, including:

- Improper rate designs that have systematically encouraged firm sales customers to retain unneeded capacity rights which would otherwise be used to provide transportation for gas to other purchasers.
- With regard to pipeline service obligations, the awareness among firm sales customers that they enjoy certificate protection as long as they remain sales customers, but lose that protection for whatever capacity they convert to firm transportation.
- Scheduling, balancing, receipt and delivery point limitations and other tariff provisions that place burdens on independent merchants which the pipeline-merchant does not bear.
- Continuing reluctance by many local distribution companies to purchase from nontraditional merchants, for fear that their decision will be second guessed by local regulators.

This list of barriers is not exhaustive, but an examination of these factors demonstrates the difficulties which NGSA members currently face in their attempts to compete as natural gas merchants.

QUESTION: Does NGSA support the use of an interim GIC versus a permanent GIC?

ANSWER: An interim period is useful if it serves to remove regulatory impediments, mitigate structural barriers and expose customers to competition. However, the very interim nature of the proposed GIC acts as a detriment to establishing the longer term relationships necessary to foster stability in the market. Thus, an interim period may not indeed be needed, and if utilized nonetheless, should be the shortest term possible.

QUESTION: What should be the objectives of a GIC?

ANSWER: In addition to funding long-term supply, a properly designed GIC must achieve several additional objectives if it is to promote the development of a competitive natural gas market. Specifically, a GIC also should:

- Promote responsible purchasing practices by pipelines and their sales customers;
- Require sales customers to decide how and from whom they will buy firm supplies; and
- Provide market signals indicating the demand for long-term supplies, so producers can obtain the investment capital necessary to explore and develop adequate gas supplies for the future.

QUESTION: Would implementation of a GIC affect the rights and responsibilities of parties under existing gas purchase contracts and, if so, how?

ANSWER: In NGSA's opinion, neither a deficiency-based nor demand-based GIC in any way affects the rights and responsibilities of parties under existing gas purchase contracts. However, as noted in Senator Domenici's letter to the Commission of February 14, 1989, some producers are concerned that a GIC tied to spot prices would encourage or permit pipelines to exercise "FERC-out" or "market-out" clauses in existing contracts.

Unlike the Commission's prohibition on recovering variable costs through minimum bills (Order No. 380 et al.) the GIC does not undermine an LDC's performance of its contract with its pipeline. To the contrary, the very purpose of a GIC is to assure the pipeline that contractual costs are covered, and the pipelines will voluntarily design and choose the GICs they want to employ. It therefore seems unlikely that there can be any justification for a pipeline to exercise a market-out or FERC-out clauses on the basis of the GICs proposed by the Commission.

QUESTION: In connection with both types of gas charges, the FERC is considering tying the pipeline commodity rates to the spot market. What are the advantages and disadvantages of this proposal?

ANSWER: This proposal, while being highly controversial, has numerous advantages and disadvantages. For example, one might argue that the benefit of this proposal is that the spot market charges are a good indication of the short-term supply of gas and thus reflective of the current cost of gas. Accordingly, the spot price with addition of a premium would supposedly compensate the pipeline for purchase of long-term supplies. Furthermore, it is contended by some that tying the GIC to the spot price would be an excellent barometer of seasonal fluctuations in the demand for gas. On the other hand, it is argued by some that tying the GIC to the spot market has no bearing upon the costs associated with holding gas and that spot prices only reflect the price of excess gas on the market.

It should be noted that this proposal is but one of numerous proposals currently being considered by the FERC. Should the FERC decide to allow pipelines and distributors to freely negotiate the type of GIC that would be appropriate for their perspective gas requirements, it is not unforeseeable that certain pipelines and distributors may decide to adapt the spot market approach for their total requirements or for certain increments thereof. Consequently, the mechanics of a particular GIC should be worked out between the parties within certain general parameters set by the FERC.

QUESTION: It is claimed by some that tying the GIC to the spot market amounts to reinstitution of price controls at the wellhead. Is that correct?

ANSWER: What all parties want to avoid is the situation where regulations limit the market and attempt to restrict price movements up and/or down since such regulation has led to excessive overcharges and surpluses in the past. However, pipelines have always sold, and will continue to sell gas, at a weighted average cost of all their own wellhead costs. Some of these costs have necessarily been lower than the average, and some have been higher. As the pipeline contracts for new supply in the future, the same situation will likely result. Therefore, any ceiling FERC may set on the pipeline's resale price will be an average of prices above and below that. FERC will not be setting the wellhead prices.

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